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Current Issues In Probate Estate Income Tax Allocation

John M. Gradwohl*

I. INTRODUCTION

The tax laws cast a maze of various tasks upon the person who is selected to be the executor¹ of a probate estate. One of the most perplexing areas today is that of how to allocate the estate's income tax burden.

The estate in administration is provided with certain generally favorable income tax provisions. It may well be, however, that in a significant number of cases the most valuable single income tax benefit in favor of the estate is an ability to apportion its tax burden among the beneficiaries so as to save taxes. In other estates, the same income tax allocation rules may operate to impair seriously the normal probate administration. To the executor, the problem becomes one of having to make a series of choices involving valuable financial consequences, often between competing individuals or groups interested in the estate, and in many cases beyond the normally conceived concepts of executor action and fiduciary responsibility.

The purpose of this paper is twofold: *First*, to analyze the extent to which under existing law the income tax burden of a probate estate may be apportioned among its various recipients in a manner to minimize taxes—with special emphasis on the areas in which the conscientious executor will face perilous situations, the executor motivated to cut tax corners will find the path clear, and probate judges and treasury personnel will find stress put on the

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¹ The term "executor" is used to include "executor" and "administrator" by whatever title designated, or any other court appointed custodian of decedents' property. References to the Internal Revenue Code of 1954, 68A Stat. (1954), are abbreviated "I.R.C." References to final regulations under the Internal Revenue Code of 1954 in effect on January 1, 1958, are abbreviated "Reg."

normal functioning of decedents' estate administration and income tax administration. *Second*, to consider suggested changes in the existing estate income tax, and to present a proposal for revision.

II. ALLOCATION OF INCOME TAX BURDEN UNDER PRESENT LAW

The extent to which under existing law the income tax burden of a probate estate may be apportioned among its beneficiaries so as to save taxes is of critical importance where possibly conflicting interests in the estate are present. Unless competing interests are at stake on the issue, the choice is primarily one of making the technical selection necessary to save taxes.² The real imponderables of the present code lie where there are (A) competing interest groups or individuals, with respect to (B) a probate administration income tax duty or choice having valuable financial effects.

The opportunities for allocation of income tax among the estate recipients in order to save total tax dollars will, of course, depend upon the factual setting of the particular estate. To evaluate the worth of the mechanics of the present code in achieving a desirable incidence of the income tax burden of a probate estate, it is necessary to explore the outer boundaries of permissible allocation, and the consequences of the current issues present within those boundaries.

A. IDENTITY OF COMPETING INTEREST GROUPS OR INDIVIDUALS

For the purposes of this paper in analyzing the extent to which there are conflicting interests with respect to the income tax aspects of probate administration, the following chart may be helpful to represent graphically the broad lines upon which these vari-

²For recent material dealing generally with an executor's income tax duties and problems, see Falsey, *Income Tax Planning (And Pitfalls) In The Administration of Decedents' Estates*, 30 Conn. Bar J. 260 (1956); Ofsthun, *Income Tax Saving Techniques Available To An Executor*, 44 Ill. Bar J. 588 (1956); Bronston, *Tax Problems In Probating Estates*, 37 Chi. Bar Rec. 263 (1956); Sutter, *Income Taxation of Estates*, 95 Trusts And Estates 1108 (1956); Alexander, *Two Current Income Tax Problems of Executors*, 29 Ohio Bar Ass'n Rep. 752 (1956). For comparable problems under the 1939 Code, see Baker, *Income Tax Planning For Executors*, 9 Tax L. Rev. 281 (1954). For income taxation of estates and trusts, see Kamin, Surrey, and Warren, *The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries*, 54 Colum. L. Rev. 1237 (1954); Michaelson, *Income Taxation of Estates and Trusts* (1955); Fillman, *Selections From Subchapter J*, 10 Tax L. Rev. 453 (1955).

ous competing interest groups may be drawn and to define the terminology used herein.

	TAXABLE INTERESTS		NONTAXABLE INTERESTS	
	PROPERTY IN GROSS ESTATE		—PASSING THROUGH GROSS ESTATE	—PASSING OUTSIDE OF GROSS ESTATE
	PROBATE ESTATE	NON-PROBATE ESTATE		
	Persons receiving probate estate property —	Persons receiving non-probate estate property —		
INCOME TAX GROUPS	GROUP 1. Who pay income tax of estate (including estate, itself) or whose income tax may be affected by probate estate decisions.	GROUP 2. Whose income tax may be affected by probate estate decisions.	GROUP 5.	GROUP 6.
ESTATE TAX GROUPS	GROUP 3. Who pay or contribute to estate tax.	GROUP 4. Who pay or contribute to estate tax.		

Decedent's property may pass in a manner which will cause the recipient to pay or contribute to the income tax on amounts earned by the estate during administration, to have individual income tax consequences based upon probate estate decisions, or to be charged with a portion of the federal estate tax. Interests in this type of property are classified as "taxable interests," and will relate to property which will be included in the gross estate for estate tax purposes.

Within the taxable interest group, there is (i) property which passes through the probate estate, and (ii) property which is not a part of the probate estate but which is included in the gross estate for estate tax purposes. Property disposed of by decedent's last will and testament or left for intestacy passes through his

probate estate. Other interests, such as jointly owned property, an *intervivos* trust with retained incidents of ownership, and life insurance proceeds on a policy owned by decedent and payable to a named individual beneficiary, are transferred outside of the probate estate, but are within the estate tax gross estate. It will be significant to note the extent to which the nonprobate property is subjected to certain tax actions of the probate executor.

Persons who receive probate property or nonprobate property may be concerned with either income tax or estate tax aspects of the administration, or both. Where the interest is transferred free of estate tax or income tax or both, it may be labelled as a non-taxable interest to that degree. For example, a spouse receiving a formula bequest qualifying for the estate tax marital deduction will, if a state apportionment statute or similar testamentary direction is applicable, have a nontaxable interest insofar as the estate tax is involved. The interest may pass to the spouse either within or outside of the probate estate. But if probate estate property is involved, the spouse may be subject to the payment of income tax on amounts earned by the estate during administration,³ and in the case of either probate or nonprobate estate property, other individual income tax consequences may be based upon actions of the probate executor.⁴ The recipient of a bequest of specific property or of a specific sum of money paid in not more than three installments would be a contributor to estate tax, but might not be liable for any tax on estate income.⁵ A residuary legatee has both income tax and estate tax worries.

How the different interests will actually line up in a particular estate will vary as much as the dispositive arrangements in the estates involved. As a practical matter, the probate estate may contain any mixture of interests, from those estates with only personal belongings and items in everyday use (and probably some

³ This is an aspect of the distributable net income rules, discussed at pages 338-348 below, and specifically, pages 343-344.

⁴ These could involve any of the income tax consequences discussed in this paper, but see especially the use of elective deductions, pages 355-364 below, and valuation and optional valuation, pages 364-366 below. The estate tax marital deduction provides no immunity from the problems discussed herein; in fact, the operation of the deduction, itself, may be impaired in certain cases. See notes 55 and 56 below; *Estate of Levy*, 167 N.Y.S.2d 16 (Surr. Ct. 1957).

⁵ See I.R.C. § 663 (a) (1). This would depend upon the specific property involved. The recipient might be subject to an income tax on income received by the estate from the specific property bequeathed. Cf. I.R.C. § 663 (c). See pages 339-340 below.

income in respect of a decedent), to estates in which the entire property passes through probate as a springboard to the eventual testamentary plan. Issues of allocation between conflicting interests could involve virtually every possible combination. For example:

(i) The rules of distributable net income applicable to estate distributions will involve problems of allocation only with respect to the individual persons falling within GROUP 1, the probate income tax group. It will be seen, however, that in many cases the persons who fall within this group and will be required to pay an income tax based upon the estate's income will not be the same individuals who receive the income in the fiduciary accounts.⁶

(ii) Whether property is brought into or excluded from the probate estate might make a difference solely as to whether the recipient is within GROUP 1 (probate income tax group) or GROUP 2 (nonprobate income tax group), and the income taxed to the estate rather than the individual. But if only the probate residuary estate pays the estate tax, then bringing the property into the probate estate might convert a nontaxable interest, GROUP 5 (nontaxable interest passing through the gross estate), into a taxable interest, GROUP 3 (probate estate tax group).⁷ (iii) The elective use of certain expenses for estate tax or income tax will pit the interests of GROUPS 3 and 4, as estate tax payers, against GROUP 1, the probate income tax paying group.⁸ (iv) Use of an optional valuation date may mean that at the expense of paying a higher estate tax by GROUPS 3 and 4 (estate tax groups), GROUPS 1 and 2 (income tax groups) will receive a higher basis for future income tax purposes.⁹

In addition, the intensity of interest of the different individuals concerned will vary. A high income tax bracket beneficiary may be more concerned with income tax than estate tax, while a lower income tax bracket beneficiary may prefer to attempt to keep the

⁶ This is one aspect of the distribution rules discussed at pages 338 et seq. below. It is recognized that the chart is not technically precise insofar as it contains within GROUP 1 both persons who are concerned with the income earned by the estate during administration and persons whose income tax may be affected by other probate decisions, such as the valuation or optional valuation which provides an income tax basis. This was done in the interests of simplicity of illustration.

⁷ This is one aspect of the determination of property falling within an income tax "estate" discussed at pages 335-338 below.

⁸ The elective deductions are a phase of the interaction of income tax with estate tax and are discussed at pages 355-364 below.

⁹ Optional valuation is a phase of the interaction of income tax with estate tax and is discussed at pages 364-366 below.

estate tax down even if his own personal income tax is somewhat increased. The type of property involved, and its nature, use, and character, will also have an effect in determining the intensity of interest of the individual recipient.

Certain nontaxable interests may be transferred from the decedent outside of his estate tax gross estate—for example, irrevocable *intervivos* trusts and life insurance proceeds where the reversionary interest in the decedent was less than 5%, if the decedent had no retained rights. These interests fall into GROUP 6. It does not seem that any purely income tax actions of the probate executor would affect the interests of this group, although other tax-motivated moves might change the financial rights of even this group receiving nontaxable interests outside of the estate tax gross estate.¹⁰

It should be noted that there are many convincing reasons for avoiding a probate estate to the extent consistent with the over-all estate management objectives.¹¹ The problems discussed in this paper may be added thereto, although in some situations the ability to manipulate income taxes during administration could become a useful tool.

This preliminary analysis suggests only a portion of the competing interests of groups and individuals which may be affected by the various income tax decisions of the executor. The numerous interests will be explored further in the next section, which considers the extent to which they become involved in the duties and choices of the executor in allocating the income tax burden of the estate.

B. PROBATE ADMINISTRATION TAX DUTIES OR CHOICES AFFECTING COMPETING INTERESTS

Exploring the outer boundaries of the area in which an allocation of the income tax burden of a probate estate may be made involves: (1) Application of the estate and trust income tax allocation provisions, and (2) Interaction of income tax with estate tax. In viewing these problems, one should also keep in mind the different time periods at which the issues may arise or be resolved. Various issues will be encountered at the time testator plans his

¹⁰ Cf. *Brodrick v. Moore*, 226 F.2d 105 (10th Cir. 1955) (contention of advancement made for purpose of increasing amount passing to widow and qualifying for marital deduction).

¹¹ See Casner, *Estate Planning Cases, Statutes, Text and Other Materials* 87-106 (2d ed. 1956). Also see, Brake, *Selecting The Distributive Mediums In Estate Planning*, 35 Mich. St. Bar J. (No. 2) 17 (Feb. 1956).

estate, when the executor takes over the administration, during administration, at the time of final accounting or distribution, and possibly even after the formal probate administration is completed. Especially in attempting to provide a workable solution to the income taxation of probate estates, it is important to consider the appropriate time periods in the transmission of property through the estate toward which the income tax provisions should be focused.

1. *Application of the Estate and Trust Income Tax Allocation Provisions.*

(a) Property Included In or Excluded From an Income Tax "Estate."

The general income tax provisions relating to individuals also apply to "... the taxable income of estates or of any kind of property held in trust, including—(1) ... income accumulated or held for future distribution under the terms of the will or trust, ... [and] (3) income received by estates of deceased persons during the period of administration or settlement of the estate. . . ."¹² There is a critical divergence in the underlying analysis of the general scope of this provision. It is possible to view the statute as taxing any income coming into the possession and control of the executor, regardless of its source.¹³ It is equally possible to reason that the statute taxes only that income which the executor controls in a fiduciary capacity; if the executor does not have some sort of a "trust" over the property, he is not accountable for the income tax on it.¹⁴

¹² I.R.C. § 641 (a).

¹³ See Kennedy, *Federal Income Taxation of Trusts and Estates* 497, 499-503 (1948).

¹⁴ Estate income tax returns are required to be "... made by the fiduciary thereof." I.R.C. § 6012 (b) (4). Fiduciary "... means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person." I.R.C. § 7701 (a) (6). Note that a "duly authorized agent" may make the return for a person under a disability. I.R.C. § 6012 (b) (2). Also, "fiduciary" is not employed in the requirement for decedent's final return. I.R.C. § 6012 (b) (1). Personal liability for tax payments may be applied to "fiduciaries". I.R.C. § 6901 et seq. But these provisions do not necessarily mean that where there is a fiduciary relationship, the estate does not include property which is not technically held in such a capacity. Where there is no fiduciary relationship, the courts will not regard the property as falling under the estate provisions. See *United States v. Cooke*, 228 F.2d 667 (10th Cir. 1955) (2-1 decision) (legal life tenant with power of sale not taxable on gain, either individually or as fiduciary); *Prudence Miller Trust*, 7 T.C. 1245 (1946) (statute not applicable to constructive trust).

For example, under the general common law rule that the title to real estate vests immediately in the heirs or devisees, it has been held that the heirs or devisees, not the executor, are taxable for rents¹⁵ and gains and losses¹⁶ earned during the period of administration. However, applying state property law, a testamentary direction that the executor hold and manage the real estate until it can be sold advantageously and then distribute the proceeds could put the property into the "estate";¹⁷ but a precarious line might be drawn under the property law of the same state to exclude a "mere power of sale" without a power of management, if, technically, the heirs and not the executor have the fee title.¹⁸ An executor exercising a power of management over real property for an extended period of time would not be subject to the estate income tax on rents or on gains from the sale of the property if he is held to have acted only as an "agent" and not as a "fiduciary."¹⁹ But, with respect to the law of some states in which title vests immediately in the devisees, income has been held taxable to the estate on the basis that the executor had possession and control, since the beneficiary, though having a fee title, did not have an immediate right to possession.²⁰

¹⁵ See, e.g., *George L. Craig*, 7 B.T.A. 504 (1927); *Guaranty Trust Co.*, 30 B.T.A. 314 (1934). Also see Michaelson, *Income Taxation of Estates and Trusts* 5 n.16 (1955).

¹⁶ See, e.g., *Radin v. Commissioner*, 33 F.2d 39 (3d Cir. 1929) (intestate property).

¹⁷ *Anderson v. Wilson*, 289 U.S. 20 (1933) (losses; beneficiaries have no fee interest in land, merely a right to proceeds); *Commissioner v. Brinckerhoff*, 168 F.2d 436 (2d Cir. 1948); *Gamble v. United States*, 116 F. Supp. 694 (E.D. Mo. 1953); See G.C.M. 12771, XIII-1 Cum. Bull. 148 (1934); also see *Clarence Strecker*, 6 B.T.A. 19 (1927).

¹⁸ See *Weber v. Commissioner*, 111 F.2d 766 (2d Cir. 1940) (direction to sell and distribute proceeds, but no power of management, held under N.Y. law to be power in trust and not fee title); *Sam S. Brown*, 20 T.C. 73 (1953) (power held exercisable, as a matter of intent, only if other assets insufficient to pay debts); also see note 19 *infra*.

¹⁹ *Arrott v. Heiner*, 92 F.2d 773 (3d Cir. 1937) (executor managed building for 22 years as "agent," then sold and distributed the proceeds, held not "in trust"); *James W. Arrott, Jr.*, 23 B.T.A. 478 (1931) (same transaction, different parties). But cf. S.M. 4945, V-1 Cum. Bull. 68 (1926).

²⁰ *Estate of Zellerbach*, 9 T.C. 89 (1947), *aff'd per curiam*, 169 F.2d 275 (9th Cir. 1948), *cert. denied*, 335 U.S. 903 (1949); *Estate of Cohen*, 8 T.C. 784 (1947); *Estate of McBirney*, 11 P-H 1942 B.T.A. & T.C. Mem. Dec. ¶ 42,360. By analogy, the corporate constructive ownership of stock rules are applicable with respect to property subject to administration, whether or not it vests immediately in the heirs. Reg. § 1.318-3(a).

In those jurisdictions enacting the civil law rule that personal property also vests immediately in the next of kin, it has been held that income from personalty is taxable to the estate during administration,²¹ but there is some thinking to the contrary.²² It is now settled that only one-half of community property income, even personal property community income, is taxable to decedent's estate.²³ Previously, there was considerable authority that under state laws which subjected the entire community property to administration, the estate was taxable on the entire income, including the one-half over which the surviving spouse retained title.²⁴ Nonprobate property is generally outside of the scope of the income tax estate.

This gap in conceptual thinking as to just what property is included in an estate will provide a certain vaguely defined area in which, as a practical matter, there may be an allocation based upon income tax consequences. These rules should be a factor in testator's planning the distributive media of his estate plan.²⁵ In addition, they provide a device whereby a nimble executor may

²¹ Jones v. Whittington, 194 F.2d 812 (10th Cir. 1952); Kuldell v. Commissioner, 69 F.2d 739 (5th Cir. 1934); Estate of McBirney, 11 P-H 1942 B.T.A. & T.C. Mem. Dec. ¶ 42,360; Estate of Zellerbach, 9 T.C. 89 (1947), *aff'd per curiam*, 169 F.2d 275 (9th Cir. 1948), *cert. denied*, 335 U.S. 903 (1949); Estate of Cohen, 8 T.C. 784 (1947).

²² See Hibernia Nat'l Bank v. Donnelly, 121 F. Supp. 179 (E.D. La.), *aff'd per curiam*, 214 F.2d 487 (5th Cir. 1954) (vesting statute, plus demand by legatees; but the Louisiana Civil Code on settlement of decedents' estates varies significantly from the laws of other states); Jones v. Whittington, 96 F. Supp. 967 (W.D. Okla. 1951), *rev'd*, 194 F.2d 812 (10th Cir. 1952) (2-1 decision).

²³ Rev. Rul. 55-726, 1955-2 Cum. Bull. 24; Sneed v. Commissioner, 220 F.2d 313 (5th Cir. 1955) (2-1 decision); United States v. Merrill, 211 F.2d 297 (9th Cir. 1954); Blackburn's Estate v. Commissioner, 180 F.2d 952 (5th Cir. 1950); Henderson's Estate v. Commissioner, 155 F.2d 310 (5th Cir. 1946); Bishop v. Commissioner, 152 F.2d 389 (9th Cir. 1945); Estate of Woodward, 24 T.C. 883 (1955), *aff'd on other grounds sub nom.*, Barnhill v. Commissioner, 241 F.2d 496 (5th Cir. 1957); see Note, 8 Stan. L. Rev. 296 (1956). Even where the surviving spouse waived her community property right, only one-half of the property was included in the estate for income tax purposes. Wells Fargo Bank v. United States, 245 F.2d 524 (9th Cir. 1957) (2-1 decision), reversing 134 F. Supp. 340 (N.D. Cal. 1955). In some cases, these rules may discriminate against the non-community property states.

²⁴ Barbour v. Commissioner, 89 F.2d 474 (5th Cir. 1937) (community property stocks); Commissioner v. Larson, 131 F.2d 85 (9th Cir. 1942), *affirming* 44 B.T.A. 1094 (1941).

²⁵ See, generally, Friedman and Michaelson, How To Plan For The Income Of An Estate, Lasser's Estate Tax Techniques 1541, 1566-7 (1955).

act at the inception of his appointment to include or exclude property from the probate estate depending upon the income tax consequences. For the most part, this will only be to minimize the taxes of nonadverse interests; for example, to drag property into the estate and temporarily relieve it from higher brackets of the ultimate beneficiary, or to forsake custody by the estate in favor of a lower bracket beneficiary. But this sort of action could involve adverse interests beyond merely shifting the property from the nonprobate income tax group (GROUP 2) to the probate income tax group (GROUP 1). Once within the probate estate, the income becomes subject to allocation under the estate and trust income allocation rules, to the interaction of income tax with estate tax, and, perhaps, more subject to claims of the surviving spouse or creditors. Also, if only the probate estate contributes to the estate tax, then the recipients' interests would be converted from non-taxable interests passing through the gross estate (GROUP 5) to an estate tax contributing group (GROUP 3), by now being within the probate estate. Thus, although the gap may not be tremendously large on this one item alone, the stakes are quite high in that it may shift property outside of the entire scope of the estate income tax scheme, bring into the estate property which would otherwise not be a part of the probate estate for income tax purposes, and involve additional tax and other financial considerations.

(b) Distributions.

Historically, the estate has always been viewed as of the same fiber as a trust for purposes of an income tax allocation mechanism.²⁶ When the 1954 Code established a new pattern of beneficiary inclusion and estate distribution deduction, the failure to differentiate between the methods of operation of an estate and a trust created a number of serious problems in the income taxation of probate estates.

In many respects an estate and a trust are similar. Both are managed by a person acting in a fiduciary capacity in whom title

²⁶ The first effective federal income tax in 1862, the ill-fated Act of 1894, and the Revenue Act of 1913 each specifically recognized an obligation of the probate representative to file an income tax return, but the first substantive provisions dealing with trusts and estates were contained in the Revenue Act of 1916. The Revenue Act of 1918 put the general applicability provisions into virtually their present form, and the Revenue Act of 1924 set up the estate and trust distribution deduction and beneficiary inclusion pattern which, as modified in 1942, carried through substantially until changed by the 1954 Code. For practical purposes, the underlying tax allocation mechanism was the same for trusts and estates. See Int. Rev. Code of 1939, §§ 161-162, 53 Stat. 66-67 (1939), as amended, 56 Stat. 809-810 (1942).

to the personal property is vested, and both have an element of judicial supervision.²⁷ But the fundamental reason for the existence of an estate is different from that of a trust. The trust is a device for holding property for some period of time, with the trustee performing whatever duties and making whatever distributions may be called for during that period.²⁸ The function of a probate administration is to gather decedent's property, settle his accounts, pay taxes, and distribute the property as expeditiously as possible.²⁹ A one year period is the hoped for time necessary to complete the administration under many state laws.³⁰ An effect of the federal estate tax may have been to extend somewhat the normal time necessary to complete an administration, but the duty of the executor is still to make distributions as rapidly as possible under the circumstances, whereas the trustee counterpart has a primary duty of acting over a period of time.

Under prior statutes, only that amount of income distributed or currently distributable by an estate was taxable to the beneficiaries.³¹ The essential test was one of tracing the payment to its source. If the source of the distribution was income, then the beneficiary might be taxable; but if the source was corpus, the beneficiary was not taxed on the distribution, and any income remained taxable to the estate.³²

The 1954 Code established the concept of distributable net income. Under these rules, any amounts paid, credited, or required to be distributed to the beneficiaries, other than bequests of specific sums of money or of specific property,³³ are considered as being from the income of the estate to the extent of the "distributable net income" of the estate for that year.³⁴ The income is applied under a two tier system of priority: (i) first tier, the amount of income required to be distributed currently (whether actually distributed or not), (ii) second tier, all other amounts prop-

²⁷ 1 Scott, Trusts 55 (1956).

²⁸ Restatement, Trusts § 2 (1935).

²⁹ See 1 Scott, Trusts 56-7 (1956).

³⁰ See, e.g., Neb. Rev. Stat. § 30-1409 (Reissue 1956).

³¹ See, generally, Kennedy, Federal Income Taxation of Trusts and Estates § 5.17 (1948).

³² See Kamin, Surrey, and Warren, The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries, 54 Colum. L. Rev. 1237, 1246-8 (1954).

³³ I.R.C. § 663 (a) (1).

³⁴ I.R.C. § 662 (a).

erly paid, credited, or required to be distributed to the beneficiaries. Within each tier, the individual recipients are treated equally on a pro rata basis as to the inclusion amount and character of the income, unless the testator has allocated different classes of income to different beneficiaries.³⁵ The same total beneficiary inclusion figure serves as a distribution deduction in the estate's income tax return for that year, thus attempting to make the estate a mere conduit through which the income passes.³⁶

This pattern applies whether the distribution is actually paid out of income or corpus, and covers estates and trusts in the same over-all manner. It means that even if a beneficiary receives solely a corpus distribution, he may be subject to an income tax to the extent of the estate's distributable net income for that year. As defined in the statute, "distributable net income" is a modified version of taxable income,³⁷ the most important difference being that capital gains are not included to the extent they are allocated to corpus and are not paid, credited, or required to be distributed during the taxable year.³⁸

So long as the old codes simply sought out the person to whom the income items could be traced, there appeared to be no critical reason for treating a probate estate differently than a trust. There were extreme difficulties in attempting to apply the rules for determining the person considered to have actually received the income,³⁹ but the effort was one to tax the beneficiary upon receipt of a current income item whether it passed through an estate or trust.

In putting its emphasis on distributions, whether income or corpus, the 1954 Code has placed its force in the direction of the primary distinguishing feature between the estate and the trust—that of the timing and nature of its distributions. The estate has a main objective of speedy disposition of the decedent's property; a trust is a device used to achieve a holding or distribution of property over a period of time. It appears that the method of operation

³⁵ I.R.C. § 662 (b).

³⁶ I.R.C. § 661 (a). In fact, the income would not be includable by the beneficiary unless it was deductible by the estate. See I.R.C. § 662 (a) (first sentence).

³⁷ I.R.C. § 643 (a).

³⁸ I.R.C. § 643 (a) (3). See discussion pages 346-347.

³⁹ See note 32 *supra*.

of trusts was the main type of situation which was contemplated by the present code provisions.⁴⁰ There are many aspects of trust administration which the distributable net income concept will handle effectively, but this mechanism seems much less appropriate when applied to the normal probate administration. When applied to estates, the distribution mechanism creates serious inequities among the various individuals interested in the estate.

The writers have been quick to point to a number of the weaknesses in the present distributable net income scheme for taxing the income of estates.⁴¹ For the most part, the problems appear to be the result of a failure to tailor a distribution system to fit the precise operation of an estate, although some result from imperfections which have not yet been ironed out of the basic distribution scheme, itself.

(1) *General Operation of the Rules.* It is pointed out that if son A is poor and son B is wealthy, and if the executor makes a partial distribution to aid the poor son during administration, he may also be passing off the burden of the estate's entire income tax for that year to the poor son, thereby relieving the wealthy son of paying his share of the year's income tax. Or, if the executor distributes \$90,000 in corpus to X and \$10,000, the estate's taxable and distributable net income for the year, to Y, X may pay an income tax on 9/10ths of the year's income (\$9,000) and Y on only 1/10th (\$1,000). It has been alleged that the income tax resulting to A or X on distributions of corpus is actually an unconstitutional

⁴⁰ The pre-1954 American Law Institute Drafts which formed the working nucleus for the 1954 Code provisions were designed for trust operation and were only optionally available to estates. See Holland, Kennedy, Surrey and Warren, *A Proposed Revision Of The Federal Income Tax Treatment of Trusts and Estates* — American Law Institute Draft, 53 Colum. L. Rev. 316, 354-8 (1953). Congress did not employ the proposed estate method of the ALI, changed the tier system somewhat, and did not provide a special distribution treatment for estates. The committee reports are couched generally in terms of "trusts or estates" and "trusts", and do not contain specific reference to or examples of estate distribution operations.

⁴¹ See Falsey, *Income Tax Planning (And Pitfalls) In The Administration of Decedents' Estates*, 30 Conn. Bar. J. 260, 264 et seq. (1956); Ofsthun, *Income Tax Saving Techniques Available to An Executor*, 44 Ill. Bar J. 588, 592 et seq. (1956); Fillman, *Selections From Subchapter J*, 10 Tax L. Rev. 453, 470-1 (1955); Alexander, *Two Current Income Tax Problems of Executors*, 29 Ohio Bar Ass'n Rep. 752, 759 (1956). Also see ALI Fed. Income, Estate and Gift Tax Stat. 147 et seq. (Tent. Draft No. 11, 1956).

capital levy,⁴² and perhaps it might be argued that this unconstitutionally bases one person's tax on another person's income,⁴³ but these contentions may be overstating the inequity in the light of current attitudes concerning realization. However, in two recent cases⁴⁴ discussed below, the state probate courts have simply refused to apply the distributable net income concept in settling the executors' accounts, insofar as one beneficiary had benefitted at the expense of the other. The courts reasoned that the income tax rules are for payment of a tax to the federal government and not for readjustment of the rights of the parties. But, in these cases only the detriment to the losing beneficiary had to be repaid by the benefiting beneficiary; there was no further requirement that the net tax savings be shared by all beneficiaries.⁴⁵

(2) *Corpus Deductions*. Distributable net income is computed with all tax deductions, including those deductions relating to corpus, even though corresponding capital gains may not be included. This consequence was designed to prevent a wasting of corpus deductions which might not otherwise be of use to the executor.⁴⁶ It means, in effect, that where distributions are made, the income beneficiaries are given the tax use of corpus expenses and the remaindermen pay a higher tax. The distributable net income as an income computation is understated and the net corpus gain is overstated. This has been severely criticised as favoring income beneficiaries of a trust (distributee beneficiaries of an estate) over the corpus beneficiaries.⁴⁷ The problem is discussed in more detail below in connection with the extremely complex elective deduction problems which arise in the case of estates, since most estate ex-

⁴² See, e.g., Craven, *Taxation of Estate and Trust Income Under the 1954 Code*, 103 U. of Pa. L. Rev. 602, 613-4 (1955); statement of Harrison Tweed, *Hearings on Technical Amendments to the Internal Revenue Code*, Subcommittee of the House Committee on Ways and Means, 84th Cong., 2d Sess. 348-9, 352-3 (1956).

⁴³ See *Hoepfer v. Tax Commission*, 284 U.S. 206 (1931) (state tax statute); *Burnet v. Wells*, 289 U.S. 670, 683 (1933) (5-4 decision) (dissenting opinion). But cf. *Muriel Dodge Neeman*, 26 T.C. 864 (1956).

⁴⁴ *Estate of Levy*, 167 N.Y.S. 2d 16 (Surr. Ct. 1957); *Estate of Rice*, 8 Pa. D. & C. 2d 379, 410-417 (Orph. Ct. 1956).

⁴⁵ No case has yet required net tax savings to be shared by all beneficiaries. See discussion pages 360-361 below.

⁴⁶ S. Rep. No. 1622, 83d Cong., 2d Sess. 346 (1954).

⁴⁷ See Revised First Report on Estates, Trusts, Beneficiaries, and Decedents, Received By The House Subcommittee on Internal Revenue Taxation 17-20 (Nov. 22, 1957).

penses are payable out of corpus and also have an elective use as deductions for estate tax purposes.⁴⁸

(3) *Impediments in Conduit.* The use of corpus expenses accentuates another type of problem, also not peculiar to estates, which creates an impediment in the attempted conduit through the estate. Since an estate nets the figures to be included in the beneficiary's return,⁴⁹ rather than simply passing on uncombined classes of all items of income and deduction as in the case of partnerships,⁵⁰ the netting out of income items may also have the effect of reducing the value of the dividends received credit, capital gains deduction, or alternative tax on capital gains available to the distributee beneficiaries.⁵¹ Also, the noninclusion of certain types of exempt income in distributable net income could deprive a beneficiary of their favorable character in some circumstances.⁵²

(4) *Distributions to Spouses.*⁵³ It is possible that an ex-wife receiving periodic alimony or separate maintenance payments may escape the income tax which she would otherwise pay, by being

⁴⁸ See pages 355-360 below.

⁴⁹ I.R.C. § 662 (b) (items of deduction shall be allocated among the items of distributable net income as prescribed by the Secretary). See Reg. §§ 1.662 (c)-4(e), 1.652(b)-3. A proportionate amount of the expenses must be allocated to tax exempt items; the remainder may be apportioned as the executor selects.

⁵⁰ I.R.C. § 702.

⁵¹ See ALI Fed. Income, Est. and Gift Tax Stat. 96-7, 133-9, 142-4 (Tent. Draft No. 11, 1956). The amount of deduction unavailable to the beneficiaries apparently inures to the estate.

⁵² Id. at 131-2.

⁵³ The problem of widow support payments has been substantially clarified by Reg. § 1.661(a)-2(e) which treats such payments as being under the tier system only to the extent payable out of and chargeable to income under the order or decree or local law. The proposed regulations had treated widows' allowances as distributions under the tier system, which could have subjected the widow to adverse income tax consequences. See Prop. Reg. §§ 1.661(a)-2(c), 1.662(a)-3(a)(4), 1.663(a)-1(b)(5) (1956); cf. Prop. Reg. § 1.642 (h)-1(c)(1) (1956) (denying carryovers on termination). In addition to distributions, there are a number of possible income tax savings which the executor may undertake with a surviving spouse. The executor may elect to file a joint return with the surviving spouse for decedent's final tax year. I.R.C. § 6013 (a) (3). In fact, he may be under a duty to do so. See *Floyd Estate* (No. 2), 76 Pa. D. & C. 597 (Orph. Ct. 1951). Although the estate is jointly and severally liable for the full income tax, only the proportionate amount is deductible for estate tax purposes. Rev. Rul. 56-290, 1956-1 Cum. Bull. 445; cf. Rev. Rul. 55-334, 1955-1 Cum. Bull. 449 (entire joint gift tax deductible; quare whether executor must insist on contribution). The ex-

considered as a beneficiary of the estate.⁵⁴ Also, the vexing problems of the double unknown may be reintroduced into formula marital deduction clauses. Since the formula bequests will not generally come within the specific bequest exclusion,⁵⁵ the spouse might be required to pay an income tax because of the amounts received, and the valuation of the interest passing to the spouse which can qualify for the marital deduction be reduced therefor.⁵⁶

(5) *Trusts as Beneficiaries.* A trust may be a beneficiary of the probate estate, and considered as a separate entity for income tax purposes.⁵⁷ It has, therefore, been suggested that distributions be made during the years of probate administration to the trusts

ecutor should negotiate a suitable apportionment of the net tax savings with the spouse, and insure that the spouse pays her share. Cf. Kennedy, *Income Tax Problems of Decedents and Their Estates*, 48 Nw. U.L. Rev. 36, 40 (1953) (indicating that the larger corporate executors in Chicago do not regard the risk as large enough to warrant application to the probate court, even where the will has no specific enabling clause). Expenses for medical care of decedent paid by the estate within one year after death are deductible either in decedent's income tax return or in the estate tax return, at the election of the executor. I.R.C. §§ 213 (d), 2053. In some circumstances, a widow's renunciation, waiver, disclaimer, or statutory election could have significant income tax consequences.

⁵⁴ Generally, periodic alimony or separate maintenance payments are includable in full by the wife and deductible by the husband. I.R.C. §§ 71, 215. A wife receiving payments from an estate is a beneficiary of the estate. I.R.C. § 682 (b). The estate is entitled to a distribution deduction for the alimony payments, but may not take the alimony deduction of I.R.C. § 215. See note 102, *infra*. As a distribution deduction, the amount is limited by distributable net income. Under the 1939 Code, the Commissioner took the position that periodic payments must be included in the wife's income in full, whether deductible by the estate or not. G.C.M. 25999, 1949-1 Cum. Bull. 116. See *Albert R. Gallatin Welsh Trust*, 16 T.C. 1398, 1400-1 (1951), *aff'd per curiam sub nom*, *Girard Trust Corn Exchange Bank v. Commissioner*, 194 F.2d 708 (3d Cir. 1952), *cert. denied*, 344 U.S. 821 (1952); *Muriel Dodge Neeman*, 26 T.C. 864 (1956). Under the 1954 Code, the distributable net income of the estate is also the beneficiary's inclusion maximum. In a year when the estate distributes more than the amount of its distributable net income, does I.R.C. § 71 conflict with §§ 682 (b) and 662 (a)? Would the wife receive the benefit of a favorable character of the estate's income? See *Anita Quinby Stewart*, 9 T.C. 195 (1947).

⁵⁵ See Reg. §§ 1.663(a)-1(b)(1), 1.663(a)-1(b)(2)(iii).

⁵⁶ See I.R.C. § 2056 (b) (4) (B). Cf. I.R.C. § 2056 (b) (4) (A). Note that not only may the marital deduction double unknown result from the income tax "encumbrance," but the encumbrance itself depends upon the spouse's individual income tax bracket.

⁵⁷ Reg. § 1.643(c)-1. See G.C.M. 24749, 1945 Cum. Bull. 237; Rev. Rul. 57-31, 1957 Int. Rev. Bull. No. 4, at 6.

involved in the estate in order to split the income among a number of taxpayers. But suppose that testator's bequest to a testamentary trust is of a corpus amount which will not qualify for the specific bequest exclusion, and that X is the life beneficiary and Y the remainderman of the trust. If the executor distributes \$10,000 to the trust, this amount would constitute trust corpus under normal trust accounting rules, but under the distributable net income concept, the trust may be required to pay an income tax of \$2,500 (tax on \$10,000 taxable income). Thus, the corpus may be reduced from \$10,000 to \$7,500; possibly, X may be called upon to replenish a portion of the income tax out of future earnings; and, in any event, the future earning power of the trust will be diminished. The rest of the probate estate has benefited by paying a lower income tax. Stated in this fashion, it would seem that the executor might be in danger in making this distribution. On the other hand, an executor may be surcharged for delaying administration unreasonably. This situation with respect to the residuary trust is only a specialized application of the general distribution issue, but it is highlighted because of the apparent intrusion upon trust accounting concepts.⁵⁸

(6) *Basis Adjustment—and Distribution of Appreciated Property.* As a phase of the payment of an income tax by a beneficiary receiving a corpus distribution, it should be noted that the distributee beneficiary may not receive an increase in the basis of the distributed property for the taxes paid. Assume that property held by decedent at death and having a then value of \$1,000 has since increased in value to \$1,200, but that in the interests of the over-all estate the optional valuation date is not elected. The property is distributed to B in a year of administration for which the value of the total distributions does not equal distributable net income of the estate, and the distribution is not in satisfaction of a specific bequest. B may be required to include in his individual return \$1,200 of the estate's income for the year of distribution.⁵⁹ Normally, the basis of property received "as income" becomes the value at which it is taken into account for income tax purposes.⁶⁰ But here, the income tax inclusion value is presumably applied to establish a basis for the property received by the estate as income, since it is not the distribution which is income, but the receipt by

⁵⁸ See Falsey, *Distribution By Estate To Residuary Trust*, 96 *Trusts and Estates* 405 (1957).

⁵⁹ This assumes the most unfavorable application of the distributable net income rules.

⁶⁰ See, e.g., Maurice P. O'Meara, 8 T.C. 622, 633 (1947).

the estate.⁶¹ The basis for B's property may remain at \$1,000 under the normal basis of inherited property rule,⁶² and upon a sale at \$1,200, B may have an additional gain of \$200. B may end up with \$1,200 taxable income and \$200 gain before his ultimate disposition of the asset, which originally was a bequest having a value of \$1,000 at death. B may or may not receive some of the estate income for the year involved (with or without further income tax consequences), depending upon the governing instrument and applicable state law.

The inequity in this example has been increased by the fact that it also involves appreciated property, but apart from the double income feature, comparable basis problems exist even where there has been no appreciation. The primary issue is whether the basis of property acquired from a decedent is adjusted where the estate income distribution rules require an amount to be included as income to the distributee.

Perhaps this example is not correct and B would actually have a basis of \$1,200 for the property since he has taken that figure into income—the inclusion in income rule prevailing over the basis of bequest rule. But, if so, even more serious problems may result: (i) What is the basis for the property received by the estate which gave rise to the income? If given its full value, then there has been a double tax basis secured from a single income tax. If not, the administrative problems may be impossible. (ii) What would B's basis for the distributed property have been if under the distributable net income rules he had included only \$300 in individual income as a result of the distribution? Similar double basis and administrative difficulties would be present.

(7) *Termination Distributions.* Problems arising in termination distributions are discussed in a subsequent portion of this paper which deals with timing the duration and termination of the estate, and allocation of income, losses, and deductions upon termination.⁶³

(8) *Capital Gains.* Capital gains are taxable to the estate (and are not a part of distributable net income) to the extent they are

⁶¹ The distribution of a bequest to the beneficiary should not be confused with the satisfaction of a legacy with appreciated property, note 80 *infra*. The latter gives rise to income realization by the estate and the property acquires an increased basis in that transaction. Normally, the receipt of a bequest does not give rise to income to the beneficiary. I.R.C. § 102.

⁶² I.R.C. § 1014. By hypothesis, property retained by the estate has acquired the \$1,200 basis represented by B's inclusion in income.

⁶³ Pages 351-353 below.

allocated to corpus under the terms of the governing instrument and applicable state law, and are not paid, credited, or required to be distributed to a beneficiary during the taxable year.⁶⁴ Where not so allocated to corpus, capital gains are a part of distributable net income and may be deductible by the estate and includable by the beneficiaries. This may operate (i) to influence planning by the testator, (ii) as a means for the executor to pass additional income from the estate to the beneficiaries, the main condition being that the executor trace the capital gain to distribution rather than retention,⁶⁵ (iii) as a possible means of watering down distributions not substantially in excess of distributable net income, as computed without capital gains, with a capital gain element,⁶⁶ or (iv) in determining the type of assets to be sold where the estate needs more liquid assets and will be making some distributions.⁶⁷ The individual beneficiaries in the estate may have differing attitudes. The high income tax bracket beneficiary will desire to take any capital gains personally and have the income items taxed to the estate. The low bracket beneficiary might prefer to take the income items as an individual and have capital gains, if anything,⁶⁸ taxable to the estate. This analysis is by no means comprehensive of the problems involved, but is merely designed to point to the treatment of capital gains as another complicating factor in the present distributable net income provisions where adverse interests are involved in the estate.

(9) *Required To Be Distributed Currently; Credited or Required To Be Distributed.* In addition to completed distributions, the inclusion of income by a beneficiary and the distribution deduction available to the estate are based upon: (i) in the first tier, amounts of income for the taxable year required to be distributed

⁶⁴ I.R.C. § 643 (a) (3).

⁶⁵ See Kamin, Surrey, and Warren, *The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries*, 54 Colum. L. Rev. 1237, 1241-2 (1954).

⁶⁶ But it is not clear how the computations are to be made in a year when there is both a capital gain and a corpus distribution. See ALI Fed. Income, Estate and Gift Tax Stat. 103-4 (Tent. Draft No. 11, 1956).

⁶⁷ In addition to the character of the realization, capital gains are more readily tax retainable by the estate and ordinary income more likely to be taxed to the individual.

⁶⁸ The beneficiary might desire that neither his share of income nor gains be taxed to the estate. But, he would prefer gain over income since the value of the capital gains deduction would be greater at the estate's effective tax rate, or the alternative capital gains tax might be available. This assumes that the individual beneficiary would, in no event, be charged for the tax or taxed on more than his own share of the income and gains.

currently, whether distributed or not, and (ii) in the second tier, any other amount properly credited or required to be distributed.⁶⁹ In the case of a probate estate, it seems doubtful whether any act short of a court order for payment can constitute "required to be distributed currently,"⁷⁰ and probably not even "credited or required to be distributed."⁷¹ It would appear that the testator may be effectively deprived of the opportunity of his *intervivos* settlor counterpart to utilize the first tier as a means of income tax allocation, and, to a degree, the ability to allocate different classes of income to different beneficiaries. In fact, unless the estate is in a position to make an actual distribution during the taxable year, it may not be able to apportion that year's taxes under the distributable net income system (and, similarly, it may not face many of the distribution problems discussed in this section). Apart from these tax rules, the phrases "required to be distributed currently" and "credited or required to be distributed" do not appear to have a significant meaning in normal estate administration.

⁶⁹ I.R.C. §§ 661 (a), 662 (a).

⁷⁰ See Horace Greeley Hill, Jr., 24 T.C. 1133 (1955) (power of executor to require refunding bond). As additionally noted in the concurring opinion, *Id.* at 1140, legatees would normally have no presently enforceable rights in estate income, even though the will is construed to state the contrary, since the income is generally liable for debts and taxes, and payment is subject to the executor's and probate court's consent. The authorities cited in note 71 *infra* dealing with the phrase "required to be distributed" would apply *a fortiori* to "required to be distributed currently." Cf. *Commissioner v. Stearns*, 65 F.2d 371, 373 (2d Cir. 1933) (The phrase "... presupposes a periodic duty of the trustee, and possibly in rare cases of an executor.") An estate would not be treated as a simple trust even if all its income were "required to be distributed currently." I.R.C. § 651; Reg. § 1.651(a)(5).

⁷¹ *Estate of Zellerbach*, 9 T.C. 89 (1947), *aff'd per curiam*, 169 F.2d 275 (9th Cir. 1948), *cert. denied*, 335 U.S. 903 (1949) (present right upon petition to probate court insufficient, even with testimony of probate judge that approval would have been granted); *Estate of Cohen*, 8 T.C. 784 (1947). But note that these cases also based taxability to the estate upon executor's possession when technical title was in the heirs. *Commissioner v. Stearns*, 65 F.2d 371, 373 (2d Cir. 1933) (L. Hand: "The income must be so definitely allocated to the legatee as to be beyond recall; 'credit' for practical purposes is the equivalent of 'payment.' Therefore, a mere entry on the books of the fiduciary will not serve unless made in such circumstances that it cannot be recalled.") For valid procedures with respect to crediting, involving probate orders, see *Estate of Fossett*, 21 T.C. 874 (1954) (ordinary income and capital gain); *Estate of Igoe*, 6 T.C. 639 (1946). Cf. *Hibernia Nat'l Bank v. Donnelly*, 121 F. Supp. 179 (E.D. La.), *aff'd per curiam*, 214 F.2d 487 (5th Cir. 1954) (under La. statute only demand for payment was necessary; income taxed to beneficiary from time of demand); *Foellinger v. Smith*, 41-2 U.S.T.C. ¶ 9579 (N.D. Ind. 1941) ("... property credited within the taxable year and so credited that each of the plaintiffs was presently entitled thereto ...").

(10) *Charitable Distributions*. An estate is allowed a deduction for amounts of the current year's income, or apparently of accumulated income,⁷² which are paid or permanently set aside for charitable purposes pursuant to the governing instrument.⁷³ To obtain the deduction, the executor must trace the income item to the charitable purpose (or the charitable distribution to income).⁷⁴ The charitable deduction, itself, ranks as a middle tier in the tier system, being computed after the first tier (required current income distributions) for first tier purposes,⁷⁵ but ahead of the second tier (other distributions) for second tier purposes.⁷⁶ These computations may cause difficulties for the executor, but serious problems with respect to conflicting interests do not appear to be involved. And, although the first tier may be somewhat useless to an estate, the peg of the charitable middle tier is merely "paid or permanently set aside" for charitable purposes and this may be a more usable standard for estate operation.

(c) *Timing Administration Activities*.

(1) *Administration Generally*. In carrying out his fiduciary functions, the executor must tread lightly so that his actions will be properly timed to result in a minimum federal income tax. The problems faced by the executor in arranging for the income taxation of the estate would, by themselves, seem to constitute a substantial impediment in the normal probate administration.

The distribution problems, discussed above, were primarily problems of timing the distributions to beneficiaries. But the time at which income is realized, the character of the realization, the presence of losses or deductions, and many other factors will, in large part, determine the income tax significance of the distributions. In turn, the realization aspects are determined in part by another set of choices. As a new taxpayer, an estate is entitled to elect to report its income on a calendar year basis or on a fiscal year basis ending on the last day of any month⁷⁷ and to adopt a

⁷² Cf. I.R.C. §§ 642 (c), 662 (b). See Surrey and Warren, *Federal Income Taxation* 762 (1955); S. Rep. No. 1622, 83d Cong., 2d Sess. 350 (1954).

⁷³ I.R.C. § 642 (c).

⁷⁴ See ALI Fed. Income, Est. and Gift Tax Stat. 108 (Tent. Draft No. 11, 1956).

⁷⁵ I.R.C. §§ 662 (a) (1), 662 (b).

⁷⁶ I.R.C. §§ 662 (a) (2), 662 (b), 643 (a) (last paragraph).

⁷⁷ See I.R.C. § 441; Falsey, *Income Tax Planning (And Pitfalls) In The Administration of Decedents' Estates*, 30 Conn. Bar J. 260-3 (1956).

cash or accrual method of accounting.⁷⁸ Some decisions will require the executor to weigh an income tax advantage with an estate tax advantage and make a selection involving both substance and timing.⁷⁹ And many other choices are present as to whether the income is realized by the estate or by an individual; in addition to the leeway in inclusion of property in the probate estate, the executor faces such problems as the satisfaction of legacies with appreciated property,⁸⁰ reinvestment of casualty loss proceeds,⁸¹ and the redemption of stock to pay death taxes.⁸²

These duties are only a portion of the executor's income tax duties, the income tax duties only a portion of the executor's general tax duties, and, of course, the tax duties are, themselves, only a portion of the executor's total duties. Of primary importance to the executor is his responsibility for an efficient management of the property of the decedent. While each possible intrusion upon the administration might, in itself, be workable, it would seem that the sum total of all the added income tax considerations demanding a conscious tax timing of the administration duties would be overwhelming. Not only is the executor put in the position of having to solve in duplicate or triplicate each estate problem, but the probate court is called upon for added actions which in many respects require a redesigning of the state probate operation to fit a desired federal income tax consequence. The important decisions in property management during administration take on an omnipresent coloring of federal income tax implications. Since the executor may have

⁷⁸ See I.R.C. § 446. The cash method would normally be selected, but an accrual method could operate to spread administration expenses over the life of the estate, or to bring into the estate real property taxes which are assessed but not paid during the administration period, etc.

⁷⁹ See pages 355-356 below.

⁸⁰ See, e.g., Rev. Rul. 56-270, 1956-1 Cum. Bull. 325 (satisfaction of marital deduction formula bequest); *Kenan, Jr. v. Commissioner*, 114 F.2d 217 (2d Cir. 1940); *Suisman v. Eaton*, 15 F. Supp. 113 (D. Conn. 1935), *aff'd per curiam*, 83 F.2d 1019 (2d Cir.), *cert. denied*, 299 U.S. 573 (1936). Cf. Rev. Rul. 55-117, 1955-1 Cum. Bull. 233 (partial distribution does not involve sale or exchange). One tax savings opportunity is to trade a capital gain to the estate for subsequent beneficiary ordinary deductions. Also see Alexander, *Two Current Income Tax Problems of Executors*, 29 Ohio St. Bar Ass'n Rep. 752 (1956).

⁸¹ I.R.C. § 1033.

⁸² I.R.C. § 303. See Dean and Leake, *How To Redeem Stock Under Section 303 To Pay Death Taxes Plus Funeral And Administration Expenses*, *Lasser's Estate Tax Techniques* 1509 (1955).

extensive duties of administration to perform within a limited time, the present problems of income tax timing would appear to place an undue barrier in the normal probate administration.

(2) *Duration and Termination of the Estate.* The probate estate has an income tax existence during the period of time actually required by the executor to perform his duties of administration and settlement of the estate.⁸³ The termination distribution will result in the beneficiaries being taxed on the estate income for its last year (including capital gains) under the rules of distributable net income. The 1954 Code added a provision which permits net operating losses, capital losses and deductions unused by the estate in its last return to be carried over to the beneficiaries upon termination.⁸⁴ There are three basic ways in which the executor may achieve tax savings with respect to timing the duration and termination of the estate: (i) by extending or reducing the over-all period of administration, (ii) by regulating the flow of income to the beneficiaries upon termination, and (iii) by regulating the flow of losses and deductions to the beneficiaries upon termination.

(i) *Length of Administration.* An estate will normally terminate for income tax purposes at the time of its final distribution to the beneficiaries.⁸⁵ It will also be deemed terminated after the expiration of a reasonable period for the performance by the executor of all the duties of administration.⁸⁶ After that time, the persons succeeding to the estate property become liable for the income tax on estate income, although no particular method of making such an allocation is provided.⁸⁷ Within the limits of reasonableness, the executor is free to determine whether the estate exists for two, three, or four fiscal years; beyond this, there may be some question, but the executor may be able to show a good reason for continuing the estate as such, and, if so, the estate will continue to exist for

⁸³ Reg. § 1.641(b)-3(a). See Fillman, *Upon The Termination Of Trusts And Estates*, 8 Tax L. Rev. 317, 320 (1953).

⁸⁴ I.R.C. § 642 (h).

⁸⁵ But, action of the probate court in closing the administration and discharging the executor is not conclusive on termination for federal income tax purposes. See Ralph E. Hedges, 18 T.C. 681 (1952) (4 judges dissenting), *aff'd per curiam*, 212 F.2d 593 (9th Cir. 1954) (discharge due to fraudulent conduct of executor).

⁸⁶ Reg. § 1.641(b)-3(a).

⁸⁷ See Reg. § 1.641(b)-3(d).

income tax purposes.⁸⁸ Furthermore, apart from such action as the distribution of substantially all of the estate corpus,⁸⁹ the rules of reasonableness would not appear designed to pick out that specific portion of a year at which the estate should terminate. The executor is able to exercise a relatively free hand in selecting the precise time within the tax year of the estate or its beneficiaries at which the estate is to be terminated for income tax purposes. This time point may have considerable tax importance in synchronizing the flow of assets and income into the beneficiaries' tax pattern.⁹⁰

(ii) *Income Allocation upon Termination.* The distributable net income rules are equally applicable to termination distributions, but since all the estate's property is distributed, no items of income or gain will be taxed to the estate in that year. The final distribution is likely to be the largest distribution in the administration and to contain specified elements of income and corpus as reflected in the executor's final accounting to the court. However, as discussed above, the distributable net income scheme may cause distortions in income inclusion by the beneficiaries at the time large distributions are made. The distribution rules do not distinguish the treatment of a termination distribution; hence, the taking of properly timed termination steps may have considerable income tax importance.

(iii) *Loss and Deduction Allocation upon Termination.* Net operating losses or capital losses unused by the estate in its final year may be carried over to the beneficiaries to the extent they would have been allowable to the estate in a taxable year subsequent to the year of termination.⁹¹ Other unused deductions of

⁸⁸ Actually, this period of time may be unduly conservative, but it should represent the time for which the executor will be able to continue the estate without income tax question under the present regulations. Where justifiable reasons have been shown, estates have been continued for 10 years or more. See Kennedy, *Income Tax Problems of Decedents and Their Estates*, 48 Nw. U.L. Rev. 36, 49 (1953) ("The Commissioner has litigated quite a few of these cases in the past eight or nine years and has won about half the time. If it is desirable to maintain the estate as an extra taxpayer beyond the time within which a reasonably diligent executor could complete the administration, the executor should certainly not request an early audit of the estate tax return. Just what steps he should take or should refrain from taking is, like the proverbial family skeleton, not a proper subject for public discussion.").

⁸⁹ See Reg. § 1.641(b)-3(a) (last sentence).

⁹⁰ See I.R.C. § 662 (c). The beneficiary includes estate income in the return for his individual tax year in which the estate's tax year ends.

⁹¹ I.R.C. § 642 (h) (1); Reg. § 1.642(h)-1.

the estate may be carried over and used in the taxable year of the beneficiary in which the estate terminates.⁹² These provisions offer possibilities for tax savings by the executor varying from the mere carryover of otherwise unused losses or deductions, toward which the section was apparently intended,⁹³ to the outright manipulation of intentionally creating a deduction which will be carried over to a high bracket beneficiary in whose hands it has a greater tax value. For example, an estate might make a final distribution to the low bracket beneficiary in 1958, then early in 1959 pay large costs of administration, make final distribution to the high bracket beneficiary, and terminate. The income tax for 1958 has been shifted to the low bracket beneficiary under the distributable net income rules, and the termination deduction carryover provision gives the high bracket beneficiary the full income tax benefit of the administration expenses. The over-all estate has saved tax dollars, but, in the process, the high bracket beneficiary has benefited financially at the expense of the low bracket beneficiary.

(3) *Effect Upon Fiduciary Responsibility.* To a degree, the income tax duties of the executor, which become highlighted by the timing considerations, place a strain upon the underlying fiduciary responsibilities which are stated generally in terms of the highest degree of obligation. It would be an overstatement to say that an executor must hold the estate's federal taxes to their absolute minimum. But, unlike a private individual, he must use his reasonable efforts to minimize taxes.⁹⁴

More than just over-all tax dollars are involved in the decisions which must be made. In many instances, the problems encountered in minimizing taxes place the executor in the difficult position of

⁹² I.R.C. § 642 (h) (2); Reg. § 1.642(h)-2. For definition of the term "beneficiary" and allocation of the carryovers among beneficiaries, see Reg. §§ 1.642(h)-3 to 5. For use by a residuary trust or the beneficiaries thereof, see Rev. Rul. 57-31, 1957 Int. Rev. Bull. No. 4, at 6.

⁹³ See S. Rep. No. 1622, 83d Cong. 2d Sess. 340 (1954). But cf. Fillman, *Selections From Subchapter J*, 10 Tax L. Rev. 453, 474-7 (1955).

⁹⁴ Where adverse interests are not involved, the executor's duty is presumably that of the normal fiduciary—to use his reasonable efforts. As a general rule, it would seem that an executor could be surcharged for an overpayment of taxes, and a good faith intention to benefit the beneficiaries would be immaterial. Where adverse interests are concerned, some authorities seem to assume that the executor's duty is to minimize the taxes, even at the risk of injury to a particular interest, but other sources indicate that the executor may be surcharged by the injured parties for such actions. See note 108 *infra*. What extraneous statements do appear from time to time seem to be more the result of the writer's own personal feelings toward the tax than of an actual body of fiduciary law.

having to act with respect to competing interests. Granted that the executor has a duty to minimize income taxes wherever legally permissible and in the interests of the estate, the question still remains as to whose income tax (or estate tax) is to be minimized. Is the executor's duty limited to the use of the estate or trusts as separate entities to save the income taxes of higher bracket beneficiaries? Or could the executor force a distribution on a lower bracket beneficiary for the purpose of saving taxes to the entire estate? In the alternative: Is the executor personally liable if he distributes to a high bracket beneficiary sooner than he might actually need and the result is a higher income tax? Could the executor be compelled to make a partial distribution to a low bracket beneficiary for the purpose of saving income taxes? Could the benefiting beneficiary be compelled to pay a part of the tax of the nonbenefiting beneficiary where there is no element of detriment,⁹⁵ or could a distributee beneficiary be compelled to share his tax savings with the other estate recipients where tax savings had been a motive for the distribution?

The critical issue in this analysis is whether the executor can or must pit the various competing interests against each other and then make some choice as to how those interests should be evaluated. Though it would save tax dollars to have the low bracket beneficiary pay the income tax of the estate, that person may be the one to whom the money would mean the most in terms of its real value. Or, the low bracket beneficiary may simply have squandered his previous wealth and have no appreciation of the value of money.

In taking actions in this area, the executor must move without being able to rely upon any definitive answers. There is no formal mechanism whereby the various rights can be adjusted to rectify the tax consequences, aside from a court direction. The executor may protect himself from personal liability to a large extent by beneficiary consents and court approvals, but this procedure is difficult, time consuming, and costly. The effectiveness of any testator direction of these activities will be greatly limited by the multitude of unknown variable factors.

The guiding direction which the conscientious executor will wish to supply will be made quite difficult by the presence of these tax rules. The less conscientious executor may be able to conduct

⁹⁵ The cases to date, discussed at pages 358-361 below, have required readjustment only to the extent of the detriment of the injured parties. It would seem that the benefiting beneficiary should also share the net tax savings with the other interests in the estate.

his own game of "hand is quicker than the eye," or he may miss the income allocation issues entirely. To the extent that nonexpert executors are involved, or in estates where the beneficiaries cannot agree upon the degree to which allocation for income tax savings should be undertaken, the path of the Code is over thin ice without the benefit of a body of state fiduciary or probate law to provide any really useful signposts. Furthermore, this discussion assumes an ability and a willingness to apply the complex Code provisions, which may not be the case with respect to many executors and tax officials.

2. *Interaction of Income Tax With Estate Tax.*

(a) Elective Deductions.

(1) *Income Tax or Estate Tax Use.* During the course of administration, an executor may have expenses, losses, or payments which can be used as tax deductions in one of the following ways: (i) for estate tax only,⁹⁶ (ii) for income tax only,⁹⁷ (iii) for both estate tax and income tax,⁹⁸ and (iv) for either estate tax or income tax, as elected by the executor.⁹⁹ The first three types do not pose problems involving a choice to the executor or persons interested in the estate. Absent testamentary direction, the executor's duty is presumably to use his reasonable efforts to make full use of them as deductions.

With regard to certain charges involving administration ex-

⁹⁶ For example, funeral expenses, unpaid mortgages, or similar claims against the estate. Under the 1954 Code, expenses of administering property not subject to claims may also be deductible. I.R.C. § 2053 (b). See, generally, Krystal, *Deductions—Estate Tax or Income Tax?*, 94 *Trusts & Estates* 489 (1955); Baker, *Income Tax Planning for Executors*, 9 *Tax Law Rev.* 281, 287-93 (1954).

⁹⁷ For example, business expenses exclusively for carrying on business affairs of the estate, rather than in preparing for settlement and distribution. See George W. Oldham, 36 *B.T.A.* 523, 529 (1937) (prior to I.R.C. § 642 (g)).

⁹⁸ For example, accrued interest on an outstanding mortgage, accrued trade or business expenses, accounts payable, accrued property taxes, and other expenses in respect of a decedent. I.R.C. §§ 642 (g) (last sentence), 691 (b), 2053 (a) (3).

⁹⁹ See notes 100-102 *infra*.

¹⁰⁰ I.R.C. §§ 212, 642 (g), 2053 (a) (2). Administration expenses, such as executor's and attorney's fees and court costs, may not need to be directly related to income production to be deductible against income; it may be sufficient that such expenses are for the management, conservation, or maintenance of property held for the production of income. Cf. *Trust of Bingham v. Commissioner*, 325 U.S. 365, 373-7 (1945).

penses,¹⁰⁰ casualty or theft losses incurred during settlement of the estate which are not compensated by insurance or otherwise,¹⁰¹ and possibly periodic payments for alimony or separate maintenance,¹⁰² the executor may elect whether the items shall be taken as deductions in the estate tax return or in the income tax return. Here, to the extent that the expenses are used for one return rather than the other, valuable financial interests of the various estate recipients may be affected. For example, the use of the deductions for income tax instead of estate tax will increase the gross estate and thereby increase the amount to which a spouse would be entitled under a marital deduction formula bequest.¹⁰³ Use of the expenses against income will reduce the income tax and thereby increase the net value passing to the probate income beneficiaries (GROUP 1). But the persons paying the estate tax (GROUPS 3 and 4) will pay a higher tax because of the absence of the deductions for estate tax purposes. Thus, the corpus of the estate tax groups has been used to increase (i) the amount of the spouse's bequest, and (ii) the share of the income beneficiaries. And, note, that whereas the benefit runs initially to the probate income beneficiary

¹⁰¹ I.R.C. §§ 165 (c), 642 (g), 2054.

¹⁰² See Rev. Rul. 56-43, 1956-1 Cum. Bull. 210 ("Although section 642 (g) of the Code refers to the disallowance of double deductions, it is the position of the Internal Revenue Service that such section contemplates the disallowance, as a *reduction* in computing the taxable income of the estate, of such items which have been allowed as a deduction in computing the taxable estate."). But cf. Reg. § 1.642(g)-1 (referring solely to administration expenses and losses during administration). The alimony deduction of I.R.C. § 215 is available only to a living husband and not to his estate. *Laughlin's Estate v. Commissioner*, 167 F.2d 828 (9th Cir. 1948). But a wife who receives amounts taxable to her under I.R.C. § 71 is considered a beneficiary of the estate. I.R.C. § 682 (b). Thus, the estate is entitled to a distribution deduction for periodic alimony payments; and it has been stated that in some situations the payments may be deducted both as a claim against the estate, I.R.C. § 2053 (a) (3), and as a distribution to a beneficiary, I.R.C. § 661. See *Estate of Daniel G. Reid*, 15 T.C. 573 (1950), *aff'd on other grounds sub nom. Izrastzoff v. Commissioner*, 193 F.2d 625 (2d Cir. 1952); *Surrey and Warren*, *Federal Income Taxation* 932 (1955). If Rev. Rul. 56-43, *supra*, is applied literally to alimony, it is not clear how alimony payments would be handled in an estate which has taken the claim as a deduction for estate tax purposes. Perhaps, the wife would be considered as a creditor rather than a beneficiary; if not, there is no method provided for making the necessary adjustments to distributable net income. Furthermore, the rules concerning the inclusion and character of the income to the wife as a beneficiary, I.R.C. § 662 (b), would appear to conflict with the full inclusion principle of I.R.C. § 71 (a). See note 54 *supra*.

¹⁰³ *Estate of Levy*, 167 N.Y.S. 2d 16 (Surr. Ct. 1957). See Rev. Rul. 55-643, 1955-2 Cum. Bull. 386; Rev. Rul. 55-225, 1955-1 Cum. Bull. 460.

group (GROUP 1), the actual benefit may be further allocated to specific members of that group by the application of the estate distribution rules discussed above.

Having a duty to act, the executor might be advised that (i) "it would be judicious to avail himself of the deduction in the place where the optimum advantage will accrue to the estate,"¹⁰⁴ (ii) where there is no estate tax, or only a nominal one, to be paid, the deduction should generally be used for income tax rather than estate tax,¹⁰⁵ and (iii) if there is doubt as to whether it is preferable for an estate to use the expenses for income or estate tax purposes, he should delay making his final choice¹⁰⁶ until the last possible moment.¹⁰⁷ Beyond this, there is no clear road to guide the executor in making the actual decision where this issue is critical. For the time being, the soundest legal advice will be that unless he has obtained beneficiary consents for his proposed action, he should request judicial instruction, and even with such consents the executor should be certain that the interested beneficiaries thoroughly understand the consequences and that appropriate probate court approval is given.¹⁰⁸ The cases which have arisen to date

¹⁰⁴ Estate of Bixby, 140 Cal.App.2d 326, 337, 295 P.2d 68, 74 (1956) ("Confronted with this elective treatment of deductions, the discreet executor will, of course, study the applicable estate tax and estate income rates and if he finds that there is a wide disparity between them, it would be judicious to avail himself of the deduction in the place where the optimum advantage will accrue to the estate, that is, by diminishing the aggregate amount of taxes payable to the federal government.").

¹⁰⁵ See Bronston, *Income Tax Returns By An Executor*, 43 Ill. Bar J. 134, 137 (1954).

¹⁰⁶ Reg. § 1.642(g)-1. The statement of waiver of claim for estate tax may be filed at any time before the statute of limitations on the income tax return. Claiming the expense for estate tax purposes does not bar its use for income tax purposes unless it has been finally allowed for estate tax. However, once the statement of waiver is filed, the item cannot thereafter be allowed for estate tax purposes. See Rev. Rul. 240, 1953-2 Cum. Bull. 79. Items may be allocated between the estate and income tax return in any desired manner, year by year, item by item, and part of a single item to each return.

¹⁰⁷ A.B.A. Sec. Tax. Bull. 14 (March 1954).

¹⁰⁸ This, if for no other reason than that some authorities suggest that an executor might be surcharged for using the deductions in such a way that a beneficiary's interest is diminished, see, e.g., Rev. Rul. 55-643, 1955-2 Cum. Bull. 386; Baker, *Income Tax Planning For Executors*, 9 Tax Law Rev. 281, 293 (1954), and others indicate that an executor is not performing his duty unless he makes the maximum use of the potential tax deductions, see, e.g., Estate of Bixby, 140 Cal. App. 2d 326, 337, 295 P.2d 68, 75 (1956). See Fleming, "From Peter To Paul," 96 Trusts and Estates 1089 (1957); Thrope, *Corpus Expenses—A Fiduciary's Dilemma*, 26 N.Y.C.P.A. 484 (1956).

illustrate the extent to which the executor and probate courts will find impossible situations, especially where the proposed use of expenses for income tax or estate tax becomes entwined in the distributable net income tangle.

In *Bixby's Estate*,¹⁰⁹ there were (using rounded figures throughout) \$120,000 in administration expenses which could be used as deductions for either income or estate tax. The top estate tax rate was 49%, making the actual worth of the expenses for estate tax \$59,000. By using the \$120,000 expenses against \$160,000 estate income for the year, the estate's income tax could be reduced from \$120,000 (tax on \$160,000) to \$19,000 (tax on \$40,000) — a reduction of \$101,000. Thus, it was more profitable by \$42,000 (\$101,000 less \$59,000) to use the expenses for income tax than for estate tax.

Mrs. Bixby, the widow, was bequeathed shares of stock, which under state law carried with them all income from the date of death. She had no other interest in the estate, and succession taxes were payable out of the residuary estate. Of the \$160,000 income, \$76,000 were dividends on Mrs. Bixby's stock, so she was a 47% income beneficiary in that year. No current distributions were made, the expenses were used in the estate's income tax return, and the \$19,000 income tax was paid by the estate. When the time came to compute the amount of the \$76,000 to be actually distributed to Mrs. Bixby, the parties were faced with these alternatives:

a. Mrs. Bixby should receive the full \$76,000, since income taxes are expenses of administration, and administration costs are payable out of corpus.¹¹⁰

b. Mrs. Bixby should be charged for 47% of \$19,000, the income tax actually paid, but no further adjustment should be made. Rights of the parties are determined in this respect after taxes, and that means where the taxes may be used most advantageously. This

¹⁰⁹ 140 Cal. App. 2d 326, 295 P. 2d 68 (1956). See Note, 4 U.C.L.A. L. Rev. 111 (1956).

¹¹⁰ This was the position taken by Mrs. Bixby's guardian ad litem. Generally, administration expenses are payable out of corpus. See, e.g., *Estate of Warms*, 140 N.Y.S. 2d 169 (Surr. Ct. 1955); *Estate of Levy*, 167 N.Y.S. 2d 16 (Surr. Ct. 1957); Ill. Rev. Stat. c. 30, § 163 (1955). Recognizing that the general rule of payment out of corpus applied to administration expenses, the court nevertheless applied an "equitable principle that the burden of the tax accompanies the income and should be borne by the account into which the taxed item goes." In the alternative, the guardian argued that Mrs. Bixby should be charged merely her share of the taxes actually paid, and the lower court so held. Compare: *Third Nat'l Bank v. Campbell*, 145 N.E.2d 703 (Mass. 1957).

would cause the residuary beneficiaries to pay more estate tax, however, so the lower income tax partially represents a share of the corpus.

c. Mrs. Bixby should replenish 47% of \$59,000 (in addition to paying 47% of the \$19,000), this being her proportionate share of the added estate tax which will be charged to corpus. This leaves the corpus "whole" but gives the entire \$42,000 tax savings to the income beneficiaries. The approach reasons, in effect, that allocation of the expenses may affect the rights of the parties, but one party cannot profit at the expense of another. So long as the residuary estate is not reduced, this does not require any further amount of tax savings to be shared with the corpus beneficiaries. But, since the general administration expenses are charged to corpus, the income beneficiaries would actually receive (i) expense free income, plus (ii) \$42,000 extra in the form of tax savings.

d. Mrs. Bixby should pay an income tax computed without use of the corpus expenses, i.e., 47% of \$120,000 (tax on \$160,000).¹¹¹ Since the expenses of administration are required to be paid out of corpus, the remaindermen should be able to make use of them against either income or estate tax for their own, not the income beneficiaries', advantage. The income tax return should not change the interests of beneficiaries of an estate since no one group has an exclusive right to the use of the income tax return or to any advantages therefrom.¹¹² But, although the expenses may be solely the remaindermen's, still they are being used only against the income beneficiaries' income.

¹¹¹ This was the position taken by the executor. As an alternative, it was argued that at least the corpus impairment should be restored. Thus, both extremes were litigated in the case: Mrs. Bixby contending that either no tax or only 47% of \$19,000, the tax actually paid, should be charged to her; the executor contending that Mrs. Bixby should be charged 47% of \$120,000, the tax on \$160,000 estate income, or at least 47% of \$78,000, the tax actually paid plus the corpus invasion.

¹¹² The use of the estate income tax return is an interesting aspect of these cases. In Bixby's Estate, the remaindermen apparently wished to secure the tax savings resulting from the use of corpus expenses against the income beneficiaries' income, and to avoid the consequences of a wasted deduction. But in Estate of Rice, notes 121 and 123 below, the remaindermen employed a recomputed estate income tax return in which the corpus expenses were used in the estate income tax return against capital gain, but with the ordinary income considered as taxable to the distributee beneficiaries. As yet, no case has litigated the proper use of the estate income tax return for making the adjustment. This leaves unsettled the crucial issue specifying the mechanical criteria upon which recomputation, if any, is to be made.

e. Mrs. Bixby should repay 47% of a figure more than \$78,000 (\$59,000 plus \$19,000) and less than \$120,000 (tax on \$160,000). This would recognize that the executor in allocating the expenses to income tax instead of estate tax is acting for the entire estate, both income beneficiaries and remaindermen. Even though the extremities would be fixed, since there are no particularly significant criteria for setting the final figure within this area, this solution could result in confusion and litigation.

Bixby's Estate, the other cases reported to date,¹¹³ and probably the bulk of the cases unreported as yet,¹¹⁴ have required the income beneficiary to pay the tax on income and have adopted alternative "c," a sort of "replenishment" theory which permits the income beneficiaries to retain the entire net tax savings, but requires them to replenish the amount of the principal invasion. In these cases, the significant figure for replenishment has been the added estate tax which the remaindermen were forced to pay. It is probable that there will be further litigation urging alternatives "d" or "e". After all, Mrs. Bixby and her fellow income beneficiaries ended up with expense free income plus \$42,000 extra, the entire net tax savings. The corpus beneficiaries received none of the net savings.

Similarly, a New York Surrogate recently required restoration of a \$7,000 corpus reduction incurred in securing a \$25,000 income tax saving, but left intact the increase in amount passing to the widow under a marital deduction formula bequest.¹¹⁵ The widow benefited by the increased share, the income beneficiaries benefited by the \$18,000 net tax savings, but the remaining corpus beneficiaries as such did not receive any share of the net tax savings.

¹¹³ *Estate of Warms*, 140 N.Y.S.2d 169 (Surr. Ct. 1955); *Estate of Levy*, 167 N.Y.S.2d 16 (Surr. Ct. 1957); *Estate of Inman*, 136 N.Y.L.J. No. 108, p. 6, col. 5 (Surr. Ct. Dec. 6, 1956).

¹¹⁴ See Fleming, "From Peter to Paul," 96 *Trusts and Estates* 1089 (1957); Trautman & Wolf, *Income Tax Problems in Trust and Estate Administration* 64 (unpublished paper in Harvard Law School Library 1955) (field study indicating that some bank fiduciaries are requiring that the income beneficiary agree in advance to restore the corpus invasion); Sutter, *Income Taxation of Estates*, 95 *Trusts and Estates* 1108, 1110 (1956).

¹¹⁵ *Estate of Levy*, 167 N.Y.S.2d 16 (Surr. Ct. 1957). But in spite of the fact that the Court permitted an increase in the widow's bequest by one-half of the amount of the deductions used for income tax purposes, the opinion states: "The election permitted by the Internal Revenue Code does not authorize the executors to vary the interest of the legatees." *Id.* at 18. See, generally, Bronston, *Tax Problems of Formula Type of Marital Deduction Bequest*, 1957 A.B.A. Sec. of Real Prop., Probate and Trust Law Proc. 96.

The Massachusetts Court has reached an apparently contrary result in an analogous trust situation, however.^{115a} The trust received dividends which were treated as a return of capital for federal income tax purposes, and thus reduced the tax basis of the assets. Under Massachusetts law, the dividends were paid to the income beneficiaries, who treated the income as nontaxable. Later, the trust corpus was sold at a profit, causing an additional capital gain to result from the decreased income tax basis. The remaindermen, being required to pay the increased tax on capital gains, urged that the income beneficiaries should be charged with so much of the tax as was occasioned by the reduction in basis due to the dividends received by the income beneficiaries. In the interests of simplicity of trust administration, the Court refused to require any reimbursement by the income beneficiaries.^{115b} The income beneficiaries received nontaxable income and the remaindermen were left with a tax on that much more capital gain.

(2) *Effect of Distributions Upon Income Tax Use.* The most difficult problems under the present code provisions are in the area where the elective deduction becomes entwined with the distribution rules. How would current distributions have affected the rights of the parties in *Bixby's Estate*? For illustration purposes, assume that the specific bequest exclusion were not applicable to the *Bixby* facts.¹¹⁶ (i) Suppose the \$76,000 dividends had been distributed currently to Mrs. Bixby. Since the beneficiary's taxable income is limited to distributable net income, she

^{115a} *Third Nat'l Bank v. Campbell*, 145 N.E.2d 703 (Mass. 1957). See Rev. Rul. 24, 1953-1 Cum. Bull. 263; but cf. *McCullough v. Commissioner*, 153 F.2d 345 (2d Cir. 1946); *Florence M. Sweet*, 44 B.T.A. 871 (1941), nonacq., 1941-2 Cum. Bull. 23. It is interesting to note that the *McCullough* case, and the precedent therefor, *Johnson v. Helvering*, 141 F.2d 208 (2d Cir. 1944), involved one of the situations which the distributable net income tier system of the 1954 code was designed to cure. Those decisions, however, may not have been applied by the commissioner if Rev. Rul. 24, supra, were followed, and this situation can still cause serious problems, as illustrated by *Third Nat'l Bank v. Campbell*, supra.

^{115b} *Id.* at 706 ("In practical operation, the application of the principle behind this ingenious contention would destroy the simplicity of the Massachusetts rules of allocation of trust receipts and expenses as between life tenant and remainder interests and might even work with great unfairness."). See note 112 supra; notes 117, 120, 123 and 124 infra.

¹¹⁶ The actual facts involved a specific bequest of 19,000 shares of stock. I.R.C. § 663 (a) (1). This operates to protect a corpus distribution of the shares, but quare whether it would also protect a distribution of accumulated income from the shares? The separate share rule is not applicable to estates. I.R.C. § 663 (c).

would have been taxed individually on only \$40,000 (\$160,000, estate income, less the \$120,000 expenses). What would she have been required to replenish?¹¹⁷ (ii) How would the presence of capital gains have been taken into consideration? Had the income other than Mrs. Bixby's dividends been capital gains, and only the amount of the dividends distributed, there would have been no distributable net income,¹¹⁸ so Mrs. Bixby would have had to include none of the distribution as income in her individual return. To what extent would Mrs. Bixby be required to replenish in this situation? Would the result be different if Mrs. Bixby were in a higher income tax bracket than the estate?

Furthermore, if the specific bequest exclusion does not operate to protect the accumulated income element of the bequest, Mrs. Bixby may be subject to additional income tax consequences in the year of its distribution, to the extent of the estate's distributable net income in the later year. Even if such a tax rests generally with the distributee alone, could payment of the tax resulting from a distribution be taken into consideration in the fiduciary accounting for the consequences of elective deduction use?¹¹⁹ If so, there would be a difference if Mrs. Bixby's individual income tax bracket were higher or lower than the estate's. If Mrs. Bixby reimburses the estate for its tax payments or the estate reimburses Mrs. Bixby for her tax payments, is there a possibility that such reimbursement of taxes gives rise to additional taxable income?¹²⁰

¹¹⁷ In this example, Mrs. Bixby will pay the tax on the entire distributable net income, and the rest of the estate income will not be subject to tax. Mrs. Bixby has benefited from the corpus expenses by having to include only \$40,000 in income instead of \$76,000, but compared with the other income beneficiaries who are charged for no income tax, she has been injured. Thus, she has benefited at the expense of the remaindermen, but not in the same amount as the other income beneficiaries. If the net tax savings are to be apportioned, it would seem to be necessary to know Mrs. Bixby's individual income tax rate to determine her actual tax benefit in solving the mathematical problem involved. But, if this is the case, should the tax brackets of the other estate beneficiaries also be considered in order to equitably weigh the net tax savings? And the problem would be further complicated if distributions were made to the other beneficiaries.

¹¹⁸ The \$120,000 expenses would cancel out Mrs. Bixby's \$76,000 dividends.

¹¹⁹ At least, this would seem to be a factor which the executor should take into consideration in planning the estate operation.

¹²⁰ To the extent that the parties intentionally engage in a manipulation of income tax which is later reimbursed by the benefiting parties, there would appear to be the possibility of added income tax consequences to either the party whose income tax is reimbursed by another, or to the

In *Estate of Rice*,¹²¹ a trust had taxable interest and dividends of \$395,000 and long term capital gains of \$402,000 for 1954. None of the capital gains were distributed. The trust had administration expense deductions of \$202,000 charged to "principal" and \$154,000 charged to "income." Using proper fiduciary accounting rules, the \$241,000 trust income (\$395,000 less \$154,000) was distributed to the income beneficiary. However, applying the concept of distributable net income only \$39,000 was taxable to the income beneficiary (\$395,000, less \$154,000 and \$202,000).¹²² But the trust was required to pay approximately \$100,000 income tax on the capital gains for 1954. The state probate court held that since the trust would have paid no income tax if the principal expenses had been applied against principal income (\$402,000 capital gain, less \$201,000 capital gain deduction¹²³ and \$202,000 corpus expenses), the \$100,000 should be charged entirely to "income" so that principal would not be used to pay the tax on ordinary income. Thus, the income beneficiary was required to repay the value to corpus of the tax deductions allocated to the income beneficiary by the 1954 Code rules of distributable net income; but the income beneficiary still

party whose income tax is paid for him for a fee. Also, where reimbursement is to be made in the fiduciary accounts, it would seem that the executor would have a duty to withhold the amounts which will be required to be repaid. But the amount may be impossible to calculate at the time of the proposed distribution. See *Third Nat'l Bank v. Campbell*, 145 N.E.2d 703 (Mass. 1957).

¹²¹ 8 Pa. D. & C. 2d 379 (Orph. Ct. 1956). No appeal was taken since the life beneficiary died some time after the trial.

¹²² This is the consequence of the corpus deduction problem, discussed at page 342 above.

¹²³ I.R.C. § 1202. Note that the tax paid was computed using the alternative capital gains tax, but the tax for purposes of readjustment was figured using the ordinary capital gains deduction. Had there been no distributions, the alternative tax would also have been advantageous, but there would have been an income tax paid by the estate. Would the remaindermen be charged a proportionate amount of the estate income tax had there been no distribution, or would the estate income tax be recomputed as if there had actually been a distribution? The interests of the remaindermen are different in this situation than in *Bixby's Estate*, note 112 *supra*. There, the remaindermen would desire to compute the fiduciary accounting as if there had been no distribution in order to secure the full benefit of the corpus expenses, even if a distribution had in fact been made. In *Estate of Rice*, the remaindermen would desire to have the fiduciary accounts assume there was a distribution, so as to avoid a contribution to income tax as otherwise computed, whether or not there was an actual distribution.

retained the entire net tax savings of \$70,000.¹²⁴ The amount of repayment was not based upon use of the expenses by the remaindermen against estate tax, but against income tax, and even then with a court-imposed engrafting of some fiduciary accounting concepts in lieu of the statutory distributable net income scheme.

Estate of Rice is only the first word on the effect of distributable net income upon the use of administration expenses. The really tough problems will arise in estates where there could be both distributions and an election to use the expenses for estate tax purposes.¹²⁵ Here, someone will have to untangle the effect of the deductions for estate tax, estate income tax under federal tax rules, estate income tax using fiduciary accounting concepts, or in the returns of the estate beneficiaries. Each general type may involve several variations, and the types could be combined in different mixtures. After these effects are computed, there is still the question of how the "tax savings" should be shared. Unless some readjustment is made as a result of the actual incidence of taxes, the financial interests of the estate recipients will be subordinated to the contingency of which allocation of the elective deductions will produce the lowest over-all tax burden at the particular time the choice has to be made.

(b) Valuation and Optional Valuation.

The valuation of the estate for estate tax purposes, or the choice whether to utilize the optional valuation date,¹²⁶ may involve a conflict between virtually any interests in the estate. The optional valuation date may be selected for either a higher or lower gross estate valuation, in any estate larger than the statutory \$60,000 exemption.¹²⁷ Whatever valuation is finally used in the estate tax

¹²⁴ To make the observation that the distributee beneficiary retained the net tax savings of \$70,000, the court must have considered the beneficiary's individual income tax rate, which approached the maximum income tax rate. This may be the forewarning of some virtually impossible computations by the executor in planning for distributions and by probate courts in approving distributions or adjusting the rights of the parties for the tax consequences thereof, where the status of the various beneficiaries is not so clearly established.

¹²⁵ See note 124 supra. In addition, the estate tax alternatives are added. *Estate of Warms*, 140 N.Y.S.2d 169 (Surr. Ct. 1955) was cited with approval in the opinion. Also see notes 117 and 119 supra. However, *Estate of Rice* does not involve the choice of use of the deductions against estate tax.

¹²⁶ I.R.C. § 2032.

¹²⁷ Rev. Rul. 55-333, 1955-1 Cum. Bull. 449; Rev. Rul. 56-60, 1956-1 Cum. Bull. 443.

return becomes the recipient's basis of the property for income tax purposes.¹²⁸ It is now settled that, absent testamentary direction, the nonprobate takers may be called upon to contribute to the federal estate tax¹²⁹—by federal statute in the case of life insurance proceeds¹³⁰ and property over which the decedent had a power of appointment,¹³¹ by apportionment statute in some states,¹³² and by judicial decision in others.¹³³ Thus, the recipients of nonprobate property included in the gross estate for estate tax purposes, such as an *intervivos* trust, a gift in contemplation of death, jointly held property, insurance proceeds and appointive assets, may have estate tax and income tax consequences based upon the action of the probate estate executor.

In a period of rising prices, the probate income tax group (GROUP 1) and the nonprobate income tax group (GROUP 2) will desire a higher valuation in order to obtain a higher basis for future gains or losses. The higher valuation can result both from fighting for the highest value within the band of reasonableness and selecting the highest of the possible dates. The probate estate tax group (GROUP 3) and the nonprobate estate tax group (GROUP 4) will wish to secure the lowest valuation in order to minimize estate taxes.

If only the probate estate property has increased in value, then the probate income tax group (GROUP 1) will want a higher valuation, and the probate estate tax group (GROUP 3) a lower valuation. But, because the estate tax rate is progressive and apportionment only proportional, the nonprobate estate tax group (GROUP 4) may also pay more estate tax. If the value of the probate property increased and the nonprobate property decreased, then the probate income tax group (GROUP 1) would want the optional valuation date for a higher income tax basis, and the nonprobate estate tax group (GROUP 4) for a lower estate tax payment; but the optional valuation would cost the probate estate

¹²⁸ I.R.C. § 1014 (a).

¹²⁹ *Riggs v. Del Drago*, 317 U.S. 95 (1942).

¹³⁰ I.R.C. § 2206.

¹³¹ I.R.C. § 2207.

¹³² For a collection of statutes, see Sutter, *How To Plan For Apportionment Of Estate Taxes*, Lasser's Estate Tax Techniques 2137, 2139 n.1 (1955).

¹³³ *Id.* at 2146-9.

¹³⁴ *Estate of Levy*, 167 N.Y.S.2d 16 (Surr. Ct. 1957).

tax group (GROUP 3) more for estate tax, and the nonprobate income tax group (GROUP 2) would have a lower income tax basis for its property.

As a practical matter, some of the property within any particular group may increase and other property decrease during the optional valuation period, so that the choice in addition to involving the group interests will be broken down into individual interests within the group. And, aside from the tax considerations, the dollar amount of property to be received by persons having a percentage share of the estate, such as the spouse receiving a formula bequest,¹³⁴ may depend upon the valuation given the gross estate for estate tax purposes. It thus appears that the executor may be compelled to make significant decisions which affect the nonprobate recipients (in the case of the marital deduction, possibly a nontaxable interest) to whom he has no clearly defined fiduciary duty, and whose interests may be opposed to the interests of the probate estate takers which he has been judicially appointed to protect.

III. A PROPOSAL FOR REVISION

A. SCOPE FOR LEGISLATIVE REVISION

Perhaps the most criticised aspect of income taxation of estates under both the 1939 and 1954 Codes has been that they have not provided workable rules for persons associated with fiduciary responsibilities. Just what rules would be workable is not at all clear. On the one hand, the relatively simple solutions for estate income taxation may be criticised as not having a sufficient depth to provide a basic equity to the parties involved. But, on the other, the more complex provisions which have been suggested from time to time in an effort to work out an underlying fairness have been criticised as being too difficult to follow, and the 1939 and 1954 Codes appear to have been widely ignored in practice primarily because of purported difficulties of application.¹³⁵ Simplicity is certainly a desired goal in designing an income tax structure, but it may not be possible to create a fully simplified federal tax law to cover probate administration activities carried on under state law

¹³⁵ Although no survey has been made of compliance with the 1954 Code, see A.B.A. Section Tax. Bull. 2 (Oct. 1955); statement of Laurens Williams, 1956 ALI Proceedings 716. Concerning the 1939 Code, see, e.g., Griswold, *Federal Taxation* 288 (4th ed. 1955); Report of The Committee on Taxation of Income of Estates and Trusts, A.B.A. Section of Taxation, Program and Committee Reports 85 (1953).

concepts which are themselves quite complex, and in many instances unsettled or in conflict.¹³⁶

The central issue with which immediate statutory revision should deal is that of providing a workable system for handling estate distributions. Of the various probate administration tax duties or choices having valuable financial effects with respect to competing interests, discussed in Part II, the distribution problems pose the most important task in creating an effective estate income tax scheme. This is not to minimize other issues, but the distribution problems are by themselves the most complicating factors, and they become even more difficult as they are magnified into other areas, such as the use of elective deductions. Along with the distribution problems are the general issues relating to timing; and as some sort of a relatively simple mechanical test is worked out which will effectively relate the income tax to the income items and their recipients, attention should be given to a reduction of the executor's present problems of timing his probate actions for tax purposes. The issues of estate duration and termination seem especially suited to legislative action.

The looseness in determining just what property falls within an estate may actually provide a useful flexibility for planning and managing the over-all estate. What problems there may be have not produced a significant volume of litigation over the many years they have existed. Although these issues will be raised in a federal court concerning state law transmission of property and the same issues may never be litigated in the state courts,¹³⁷ there would appear to be no serious reason why this area should not be left for future administrative regulation and judicial decision. Also, revised distribution rules would remove some of the income tax emphasis which now rests upon the choice whether property is included in or excluded from the probate estate.

Where the income tax becomes interrelated with estate tax,

¹³⁶ See Paul, *Taxation For Prosperity* 411 (1947) ("This perennial problem of degree permeates all legal activity. Tax statutes must be drawn so that they may be as easily understood as possible. But in the rush for simplicity they must preserve their contact with the complexity of modern life; they must be firmly rooted in our fast-moving underlying experience. . . . In tax law, as more generally, there are almost always competing considerations. What is simple may not be equitable. What is equitable may of necessity be complicated. In other words, simplicity and equity are often incompatible and we are forced to choose between them.").

¹³⁷ This appears to have been the situation in many of the cases contained in notes 15-24 *supra*.

the problems involve a placing of stress on both the internal operation of the income tax law and the correlation of estate tax and income tax. Optional valuation would appear to be of the latter type, and is more within the scope of a separate study on coordinating the workings of the two taxes than of this paper. The fact that estate property picks up a higher or lower basis is of no particular consequence to the internal operation of the estate income tax allocation system, although it may have considerable interest to the individuals involved in the estate.

The elective deductions do, however, provide a situation in which estate tax considerations may distort income tax operation. Many corpus expenses of an estate can be deducted for either income tax or estate tax. When income tax use is elected, there is an overloading of the income tax with high expenses which are likely to be paid at one time or in large blocks. This accentuates the problems of distributions, makes timing considerations more important, and, in practice, is likely to throw against income expenses which cannot be wholly justified as being true income-producing costs. Here, too, reformation of the distribution rules will alleviate the most difficult aspect of the problem. Closer administrative scrutiny should be applied to the specific expenses available for charge against income.

Insofar as the choice of income tax or estate tax use of the deductions is concerned, the apportionment of net tax savings or reimbursement for losses to particular interests within the estate would appear to be a proper function for state probate courts and for testamentary direction.¹³⁸ Having to make such adjustment is not the result of unwarranted intrusion by the federal income tax law, for, by hypothesis, with appropriate adjustment all parties interested in the probate estate will benefit at the expense of the federal government. And, in any event, the problem arises only with respect to an advantageous election exercised by the estate.

This leaves as foremost in the legislative solution stage a resolution of the issues pertaining to distributions. Solving the distribution problem is essentially that of ferreting out the various aspects of estate income and relating the tax to the person actually receiving income items or the benefit from them. It is helpful to analyze the suggested solutions which have been advanced for handling estate income taxation. Following this, there will be presented an outline of a proposal for revision and analysis of this proposal.

¹³⁸ See Fleming, "From Peter to Paul," 96 *Trusts and Estates* 1089 (1957).

B. SOME SUGGESTED APPROACHES

Consideration of the comprehensive recommendations to date involves principally an analysis of proposals of the American Law Institute and of the Advisory Group on Subchapter J of the Internal Revenue Code of 1954, to the House Subcommittee on Internal Revenue Taxation. The activities of the Institute provided the working nucleus for Subchapter J of the 1954 Code and have continued to be a driving force for further revision perfecting the operation of these sections. The Advisory Group has recently proposed a thorough overhaul for the Subchapter J mechanism.

Under the 1952 Institute Draft,¹³⁹ estates were treated as separate tax entities. Income was taxable to the estate and was not includable by the beneficiaries even though distributions were made,¹⁴⁰ but the estate could elect to be treated as a trust, in which case the general trust rules were applicable (except throwback, but including separate share).¹⁴¹ Separate entity treatment for estates was an attempt to provide a simpler treatment for the majority of estates, coupled with recognition that estates have a different method and purpose of operation than a trust, and, in general, offer fewer tax avoidance possibilities. The election to be treated as a trust was intended to give relief to the estates in which the ultimate beneficiaries are in lower tax brackets than the estate, by continuing opportunities for "skillful manipulation" of the tax liability through controlled distributions. Distributions at an early date would also permit the income to be earned by and taxed to the low bracket beneficiary rather than the estate. An unduly extended administration, of particular advantage to low bracket estates with higher bracket beneficiaries, would be cut off and the estate treated as a trust from that date.¹⁴²

The American Bar Association patterned its recommended estate income tax provisions after the 1952 American Law Insti-

¹³⁹ ALI Fed. Income Tax Stat. (Tent. Draft No. 7, 1952). For a discussion of this statute by its principal draftsmen, see Holland, Kennedy, Surrey and Warren, *A Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates—American Law Institute Draft*, 53 Colum. L. Rev. 316, 354 (1953).

¹⁴⁰ Id. §§ X875, X885 (a).

¹⁴¹ Id. §§ X876, X885 (b), X821.

¹⁴² Id. § X877 (taxable years beginning more than three years after decedent's death). This provision was not intended to limit the power of the Commissioner to treat the heirs and legatees as the true owners in the case of an unduly prolonged administration. Id. at 457, 460. See Reg. § 1.641(b)-3.

tute Draft.¹⁴³ The same elective treatment was retained in the 1954 American Law Institute proposal,¹⁴⁴ which also made the throw-back rules applicable to estates treated as trusts.

However, the 1954 Code emerged with mandatory treatment of an estate as a complex trust, without separate share or throw-back rules applicable, and with only the distributable net income tier system and the gift exclusion as a protecting dike for genuine corpus bequests. The issues which these rules may raise in probate estate administration have been outlined in Part II of this paper.

In preparing the 1954 Code, it may have been felt that simplicity would not really be provided by giving elective treatment, because the executor, instead of having to work with just one set of rules, which were, by the argument, too complex for general usage, would then have to contend with two sets of rules, one simple and one involved, plus a possibly difficult election. But, at least an easy route for many estates might have been provided. If, as it appears, fiduciary practice under the 1954 Code is avoiding a precise compliance with the statute in many cases, the early fears of the Institute over the complexity of its general trust rules as applied to estates would be borne out.

In 1956, the American Law Institute presented two alternatives for revision of the Code's treatment of estate income tax.¹⁴⁵ The first would revise the existing system, and the second would establish mandatory taxation as a separate entity for an estate in administration. Under Alternative I, (a) separate share treatment would be extended to estates, (b) widow's allowances not paid out of income, and any nonbusiness tangible personal property not exceeding a total value of \$10,000, would be excluded from the tier system, and (c) the tier system, itself, would be modified in the case of estates to include (i) in the first tier, any of the year's income required to be distributed or which is actually distributed, though not required, and (ii) in the second tier, any other distribution.¹⁴⁶ Alternative II, the officially preferred Institute position,¹⁴⁷

¹⁴³ Report of the Committee on Taxation of Income of Estates and Trusts, A.B.A. Section of Taxation, Program and Committee Reports 63, 86 (1953). The committee report received official endorsement and recommendation by the Association. 79 A.B.A. Rep. 459, 472, 492 (1954).

¹⁴⁴ II ALI Fed. Income Tax Stat. (Feb. 1954 Draft).

¹⁴⁵ ALI Fed. Income, Estate and Gift Tax Stat. (Tent. Draft No. 11, 1956).

¹⁴⁶ Id. at 148-52. Cf. II ALI Fed. Income Tax Stat. § X827 (a) (Feb. 1954 Draft).

is a proposal for mandatory treatment as a separate entity, with the trust rules applicable to taxable years beginning after 51 months, but the statute was also intended to permit the Commissioner to relate the income to the heirs and legatees directly where administration was unduly prolonged.¹⁴⁸ In addition to these estate provisions, revisions in the income taxation of trusts were also thoroughly considered by the Institute.

The 1956 Committee on Income of Estates and Trusts of the American Bar Association recommended that the estate be taxed as a separate entity during administration, but provided an election to be treated as a trust and a cut-off after 51 months, quite similar to the earlier proposals of the Association and the Institute.¹⁴⁹ The recommendation was not among the many provisions endorsed by the Association,¹⁵⁰ presumably in deference to the Institute's alternative recommendations.

During 1957, an Advisory Group on Subchapter J of the Internal Revenue Code of 1954, to The House Subcommittee on Internal Revenue Taxation, prepared a full scale report of suggested changes in the income tax structure for estates and trusts.¹⁵¹ The attack of this Group on the estate distribution problem was to provide a broadened corpus exclusion, applicable only to estates, which would exclude from the tier system any amount paid or credited out of corpus in full or partial satisfaction of a bequest, share, award or allowance during a period of administration not exceeding 36 months.¹⁵² In addition, the reports contain recommenda-

¹⁴⁷ 1956 ALI Proceedings 721.

¹⁴⁸ ALI Fed. Income, Estate and Gift Tax Stat. 152-6, 161-5 (Tent. Draft No. 11, 1956).

¹⁴⁹ Report of the Committee on Income of Estates and Trusts, A.B.A. Section of Taxation, Program and Committee Reports 92 (1956).

¹⁵⁰ 81 A.B.A. Rep. 156, 161-6 (1956).

¹⁵¹ First Report on Estates, Trusts, Beneficiaries, and Decedents, Received By The House Subcommittee on Internal Revenue Taxation (May 8, 1957); Revised First Report on Estates, Trusts, Beneficiaries, and Decedents, Received By The House Subcommittee on Internal Revenue Taxation (Nov. 22, 1957).

¹⁵² Revised First Report, Id., at 29: "Sec. 663. . . . (a) EXCLUSIONS.—There shall not be included as amounts falling within section 661 (a) or 662 (a)— . . . (2) OTHER GIFTS, BEQUESTS, ETC.—Any amount, other than capital gains considered paid, credited, or required to be distributed under section 643 (a) (3) (B), which under the terms of the governing instrument or applicable local law is an amount which is not to be paid or credited at intervals and which is properly paid or credited in full or partial satisfaction of a bequest, share, award or allowance from the corpus of a decedent's estate during a period beginning with the day following the

tions for an improved treatment of corpus deductions,¹⁵³ making the separate share rule applicable to estates,¹⁵⁴ and eliminating a number of the other specific present problems.¹⁵⁵

The Advisory Group's recommendations would appear to be an improvement over the 1954 Code provisions, in that the existing inequities whereby one beneficiary may benefit at the expense of another would be lessened. This may be all the plan purports to do.¹⁵⁶ But what is employed is admittedly a tracing approach similar to that under the 1939 Code,¹⁵⁷ and the tracing approach of the 1939 Code seems to have been admittedly impractical. Further, the estate may still be treated, at least in part, under a trust mechanism which is basically meaningless in terms of normal probate estate operation. Insofar as the estate is handled under the proposed new four tier system of allocation of income of trusts and estates,¹⁵⁸ supplanting the present two (or three, counting the charitable middle tier) tiers, the income taxation of an estate is governed by clothing tailored to fit an entirely different situation, and which does not offer workable rules for estate executors. One committee member dissented from the First Report for this reason,¹⁵⁹ but another, Laurens Williams, hastened to add in the Re-

death of the decedent and ending 36 months thereafter. A payment shall be deemed to have been made from corpus of a decedent's estate to the extent it is properly charged against corpus and designated as a distribution of corpus on the books and records of the estate by the fiduciary." In addition, the fiduciary is permitted to set aside an amount for the purpose of meeting existing or potential estate obligations which are payable out of estate income.

¹⁵³ *Id.* at 15, 17.

¹⁵⁴ *Id.* at 30, 34.

¹⁵⁵ For example, identification of capital gains, *Id.* at 14, 16; elimination of the dividends received credit problem, *Id.* at 9, 11; a new charitable deduction arrangement, *Id.* at 9, 11 (and related references); loss carryover provision is made applicable to separate shares, *Id.* at 10, 14; and certain of the present regulations have been given code status.

¹⁵⁶ See *Id.* at 31.

¹⁵⁷ *Ibid.*

¹⁵⁸ *Id.* at 24. The four tier system proposed is designed to relieve the inequities between beneficiaries receiving discretionary income payments and those receiving corpus. Under this system, the order of priority would be: (1) required to be paid currently out of current income; (2) discretionary out of current income, (3) discretionary out of current income or out of corpus or accumulated income, (4) all other amounts paid, credited or required to be distributed. Charitable beneficiaries are placed in the fourth tier.

¹⁵⁹ First Report, note 151 *supra*, 49; also, Revised First Report, note 151 *supra*, at 57.

vised First Report that although he, too, would favor taxing an estate as an individual, the Advisory Group did not consider the proposal at this time, as such an amendment would be a "major change in the taxing pattern," and thus it was held for consideration by the Group at a later date.¹⁶⁰

What the actual results of the various proposals will be when the many factors of securing legislation have been dealt with is somewhat problematical. It is heartening to note that there is considerable sentiment for designing a special set of code provisions to deal with income taxation of estates. But the horses are pulling in two directions. There is the demand for a simple method of handling almost all estates. There is also a demand to retain "substantial opportunities for minimization of tax" by the estate, especially where simply lumping everything together in one taxable entity for income tax purposes may not reach fully fair results in certain types of estates.¹⁶¹ It does seem that the nature of the legislative beast is such that it is likely to evolve some sort of elective device balancing simplicity for most estates and tax savings for a few estates where more difficult provisions may be necessary.

C. OUTLINE OF A PROPOSAL FOR REVISION

The following is an outline of a proposal for legislative revision, based upon the factors presented in this paper.

1. The estate should be treated as a distinct entity for not more than x -months.
2. Consideration should be given to whether income splitting, personal exemptions, medical deductions, etc., should be made available to the estate where the persons interested in the estate are within a sufficiently close family relationship.
3. After the expiration of x -months, or if administration is unreasonably extended (whether more or less than x -months), the Commissioner should be given the power under a specially designed version of section 482 to allocate income in a manner which will clearly reflect the actual interests of the parties (or to reflect the rights of the parties when they may ultimately become determined); in the absence of such action by the Commissioner, the estate should be treated as follows after x -months:

- a. The present separate share rule should be broadened to

¹⁶⁰ Revised First Report, note 151 *supra*, at 58.

¹⁶¹ See, e.g., Vernon, Allocation of Trust and Estate Income and Deductions Among Beneficiaries, Tax Forum No. 183, March 4, 1957 (unpublished); Statement of Kenneth W. Bergen, note 159 *supra*.

apply to estates; further, in the case of estates, the rigid requirements for qualification as a separate share should be relaxed in favor of a broad concept covering any separate interest which is discernible in fact, whether of income or corpus, or both (thus, including the present specific bequest exclusion plus any corpus bequest, income bequest, or other bequest which is capable of a separate identity); and the concept should apply to carryovers upon termination.

b. Subject to the separate share rules, the following tier system would apply to distributions:

(1) first tier: all distributions of current year's income would be includable by the beneficiaries and deductible by the estate; but any additional required income distributions (and the term should include bequests required by the governing instrument or applicable state law to be paid at any time out of the current year's income) should be taxed to the *estate*.

(2) second tier: operating as the present second tier on any income not taxed under the first tier to either the beneficiaries or to the estate.

c. Throwback rules should be applicable, unlimited in time and with perfected mechanics.

4. If there is to be an elective method within x -months (which is not recommended), then shift to the post x -months plan at that time rather than to the trust rules.

D. ANALYSIS OF PROPOSAL FOR REVISION

Taxing estates as separate entities would provide a simplified treatment for estate income taxation. But it should be frankly realized that expediency is the principal factor in this selection. True, it may be reasoned that this is merely the decedent continued for up to x more months, but it is equally plausible to urge that, in many cases, the devisees should be considered as the parties in interest as of decedent's death, and examples could be presented in which the estate would involve more than merely decedent continued.¹⁶² The entity concept does not include adjustment for the

¹⁶² These could involve various types of augmentation of estate at death in the form of capital accretions, e.g., life insurance and employee death benefits, or of income items, e.g., the various forms of income in respect of a decedent (which, additionally, may be bunched within a short period after death). Furthermore, the spouse and family may be deprived of the services and many of the tax attributes of the decedent, or of reliance upon a steady income.

fact that the composite is actually a number of individual and group interests. The income tax would be related to the income items through the fiduciary accounts, so this important aspect of relating tax to income would at least be superficially met. The tax might not represent the beneficiaries' precise individual income position, as if the estate were wholly ignored, but the inequity would seem to be less than under the present rules.

Further, there is a certain flexibility even in mandatory treatment as an entity, especially by testator planning and well-timed distributions. The use of distributions to apportion income is limited to anticipatory distributions rather than the "after the fact" distributions which could be made under both the 1939 and 1954 Codes. Those advance distributions which are made for tax purposes would seem to serve a number of socially desirable purposes, however. To the low bracket beneficiary, there is an earlier distribution which gives him wealth in a more usable form, with a lower ultimate income tax,¹⁶³ and without the possibility of distorting his individual income tax as under the present distributable net income rules. At the same time, the distributions will reduce the tax of the other estate beneficiaries by lowering the top estate income tax rate, and thus reducing the tax to be apportioned in fiduciary accounts.

It might also be that if the estate is really to be considered as decedent continued for x -months, it should be given some of the tax advantages which decedent would have had if alive. These could include, for example, income splitting,¹⁶⁴ personal exemptions, and medical deductions, when within the family group. From the standpoint of an abstract equity, this would approach the most desirable result of simply having the beneficiaries step into decedent's shoes as of the moment of death (but given certain income tax benefits), and would seem to impose little in the way of burden on probate administration. If these advantages were made available to an estate, they should be limited to close family situations in which the estate is, in reality, another member of the family income unit.

There is sizable current controversy over how an estate should be taxed when it is no longer taxed as an estate. The two leading

¹⁶³ The low bracket beneficiary taxed individually receives the benefit of his own favorable tax rate. If taxed to the estate, his share of income will be charged the average estate income tax rate as his proportionate share of the taxes paid by the estate.

¹⁶⁴ Cf. I.R.C. § 2. But this provision relates only to income taxed to the spouse, and does not cover the income which remains taxable in the estate.

concepts seem to be treatment of the estate as a trust and an attempt to relate the items of income and deduction directly to the beneficiaries. Admittedly, the trust garment does not fit the estate operation, although it may be closer at the end of *x*-months than earlier in the administration. It is not at all clear what it means to attempt to relate the income directly to the beneficiaries. The problem here is extremely difficult because it involves conjecture on conjecture. Estates in this class will involve an unknown composition of property and interests, and have an extended administration for a number of possible reasons. The equities may vary significantly from estate to estate. In this situation, it seems appropriate to give the Commissioner broad power under a specially designed version of present section 482¹⁶⁵ to allocate income in a manner which will clearly reflect the actual interests of the parties (or to reflect the rights of the parties when they may ultimately become determined). Perhaps, the trust rules would fit some extended administrations. Perhaps, the income could be directly attributed to the beneficiaries. Many other factual environments could exist and different solutions might be adopted. At least, such a power in the Commissioner would serve as an escape valve if any particularly abusive practices developed.

It is generally agreed that the separate share rules, now limited to trusts, should also be applied to estates.¹⁶⁶ To the extent separate shares exist, there will be a tendency to place corpus and income going to a beneficiary in a single unit, and to limit the beneficiary's taxable income maximum to just that income falling within his own share. This will lessen the problem of one beneficiary's paying a tax based upon another's income. Although it would seem advantageous to recognize the separate share at the earliest possible time in the administration, it may be impossible (i) in the initial stages, and (ii) under state law or dispositive arrangements which do not operate as presently defined separate shares. For a period of time after assuming the administration duties, an executor may lack the full information necessary for separate share treatment. Further,

¹⁶⁵ I.R.C. § 482: "In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

¹⁶⁶ I.R.C. § 663 (c); see notes 146 and 154 *supra*.

as presently defined, to be considered as separate, the interest must be substantially the same as if separate trusts had been created,¹⁶⁷ the corpus interest of one beneficiary cannot affect the income interest of another beneficiary,¹⁶⁸ and the concept is not applicable to loss or deduction carryovers on termination.¹⁶⁹ Separate trusts, segregation of assets, or separate individual beneficiaries are not required,¹⁷⁰ but the requirements still appear to demand at least a capability of operation as an independent unit.

My suggestion would be that the separate share rule should, in the case of estates, be broadened to cover any separate interest which is discernible in fact, whether of income or corpus, or both. This rule would engulf the present specific bequest exclusion so far as estates are concerned.¹⁷¹ The specific bequest would be a discernible share and would be permitted to operate as such. The segregation of income and corpus elements would be handled under the distribution system discussed below.

The operation of this sort of a separate share rule is basically a tracing concept, but a different type of tracing would be involved than was used under the 1939 Code. Under the old code, the attempt was to trace items of income through the estate to the ultimate recipients. My attempt is to trace the various interests of the estate into their respective or separate shares. True, not every interest is capable of being excised in this manner and of having its own definitized boundaries. But many items involving either corpus or income or both will be distinguishable, and in these cases the federal income tax may be keyed to taxing that share in terms of its ultimate recipient. It should be pointed out that this rule would come into play only after *x*-months and then only if the Commissioner has not specified some other method for reflecting clearly the estate's income. Under the existing code, a separate corpus interest may be denied separate share treatment because related income does not also operate as a separate share.¹⁷² Actually, that

¹⁶⁷ See Reg. § 1.663(c)-3(a).

¹⁶⁸ Reg. § 1.663(c)-3(b).

¹⁶⁹ Reg. § 1.663(c)-1(b) (4).

¹⁷⁰ Reg. §§ 1.663(c)-1(c), 1.663(c)-3(c).

¹⁷¹ I.R.C. § 663 (a) (1). It is also intended that the three installment aspect of this rule would be unnecessary under the proposed separate share rules and distributable net income tier system. In appropriate situations, it could be made applicable as a part of the trust income taxation rules where the Commissioner, exercising his section 482 type power, feels this is warranted.

¹⁷² See Reg. § 1.663(c)-3(b).

income may well be operating as a separate, separate share, and, especially if the throwback rules become applicable, it would seem wise to treat the income interest as its own separate share. It would also seem wise to permit marital deduction formula bequests to operate as separate shares, at least with respect to the corpus portion, so as to preclude a possible double unknown valuation problem.

Perhaps this separate share rule is more a separate interest rule. The attempt to trace income under the 1939 rules became a form of shell game. But the executor in managing an estate must be able to identify the various interests in the estate, and to account eventually to the court for their satisfaction. To this extent, there is a breakdown of the estate into its many interest elements and eventually a coordination of amounts received with those interests. It is recognized that this analysis is an oversimplification, and that many estates will not fall into this type of neat pattern. Still, where the executor is able to pattern his estate into discernible shares, the estate should be given the full benefit of this treatment. Since separate share treatment would not be elective, it should be geared to fiduciary accounting so that it would not have an element of second guess (or second computation) in rearranging the executor's records. And it does seem that separate share treatment should be applicable to loss and deduction carryovers upon complete or partial termination, for these are the points at which separate shares may be most significant and also most readily reflected in the fiduciary records.

So designed, the separate share rule would remove much of the stress from a tier system relating to distributions. I would propose the following tier system, but it should again be noted that this tier system would come into play only after the expiration of x -months.

(1) first tier: all distributions of current year's income would be includable by the beneficiaries and deductible by the estate; but any additional required income distributions (and the term should include bequests required by the governing instrument or applicable state law to be paid at any time out of the current year's income) should be taxed to the *estate*.

(2) second tier: operating as the present second tier on any income not taxed under the first tier to either the beneficiaries or to the estate.

This would operate essentially as the proposed American Law Institute Alternative I, but with one structural change. The first tier as presently drawn is comparatively meaningless to an estate. It is difficult to qualify for a required distribution, apart from an actual distribution, or to allocate classes of income to different bene-

ficiaries.¹⁷³ Yet, there seems to be an agreement that the testator should be in a position to spell out bequests of the income during administration if he desires; and such bequests should not, because of federal income tax considerations, materially disrupt a probate administration. There will be cases in which a partial corpus distribution would be possible but an income distribution would need to await a more complete accounting by the executor. The American Law Institute draft partially alleviates the situation by providing that any income which is in fact distributed is in the first tier. This may assist some estates. But it does not provide sufficient freedom for testator planning, and, as a result, many attempted first tier devices will fall back into the second tier, if current income payment is not possible during the year. And even if undistributed income payments were within the contemplated first tier, it would seem unfair to tax the estate beneficiary (as contrasted with a trust beneficiary) in advance of distribution.

The proposed tier system taxes some income to the estate ahead of the second tier, instead of merely putting all income up for taxation to the beneficiaries. Required distributions to be paid at any time out of the current year's income may remain taxable to the estate during the current year. This gives the testator more freedom than under the present rules to plan the actual income tax allocation within his probate estate. Such freedom results from the broadened separate share rules which will include a wholly income share if it is in fact separate, and in giving the first tier the broader meaning consistent with normal probate estate operation. Thus, testator's direction to pay a class of current income to B, whether to be paid currently or at the completion of administration, would eventually be taxed or charged to B and not to a beneficiary who merely happens to receive a second tier distribution in the year the income is earned.

To assist in taxing the income to B, the actual recipient, in those cases in which the administration has exceeded *x*-months, the throwback rules¹⁷⁴ could also be made applicable. The present time limits on the throwback period would no doubt be sufficient, but they should not be used, in order to avoid any temptation for an unduly extended administration. It is assumed that in the process of revision of Subchapter J, the working mechanics of the throwback rules will be improved so as to eliminate the complexities of

¹⁷³ Discussed above, pages 347-348.

¹⁷⁴ I.R.C. §§ 665-668.

operation and inequities of the present rules.¹⁷⁵

This analysis does not fully resolve the issues involved in establishing a workable mechanism for the income taxation of estates. Most of the problems discussed in Part II would be solved for the administration which is completed within x -months. A number of questions for the estate which continues beyond that time have been left unresolved, and only a primary superstructure has been presented. The main problems would be to integrate into this system a treatment for corpus gains and expenses and charitable distributions.¹⁷⁶ It is felt, however, that much of the present strain which these problems place on the present system would be removed by the revised approach. The most significant contribution of a revised distribution plan would be to reduce the areas in which the executor is presently forced to make significant tax decisions which can have valuable financial consequences with respect to competing interest groups within the estate. This is an impediment which the federal income tax law places in state probate administrations. To the extent the federal tax law attempts to untangle the interests of the estate recipients in the same general manner as the state probate courts, the impediment is reduced.

Present sentiment may be shifting toward simplified treatment of estate income taxation even at the expense of having certain imperfections in the tax system.¹⁷⁷ Whether an elective method within x -months is worth the complexity it would add appears doubtful, but an election might be useful in some cases. As a matter of securing legislative relief, one can only speculate whether it is more desirable to present a single simplified plan which may have some inequities, or two plans and an election which may come closer

¹⁷⁵ These problems relate primarily to the method in which tax payments by the estate are treated. See Kamin, Surrey, and Warren, *The Internal Revenue Code of 1954. Trusts, Estates and Beneficiaries*, 54 *Colum. L. Rev.* 1237, 1251 (1954); ALI *Fed. Income, Estate and Gift Tax Stat.* 122-8 (Tent. Draft No. 11, 1956). The present rules may operate unfairly with respect to different trust beneficiaries. The beneficiary getting the first accumulation distribution also receives a tax advantage as compared with later accumulation distributees. But, with respect to the individual beneficiary, himself, the tax can be no higher than if distribution had been made in the year of accumulation, I.R.C. § 668 (a), although his individual tax on the distribution may be less than the tax credit which he receives in the year of distribution.

¹⁷⁶ This appears to have been effectively undertaken in the Advisory Group Report, notes 153 and 155 *supra*.

¹⁷⁷ See, e.g., statement of Stanley S. Surrey, 1956 A.L.I. Proceedings 714; notes 159 and 160 *supra*.

to making everyone happy. From the practical nature of legislative evolution, the next step in the federal tax law may be in the direction suggested by the American Law Institute in 1952—one really simple scheme to take care of run of the mill estates (which will be most of them by number), and one detailed set of rules reaching a more precisely equitable result in those estates where the desired tax consequences are worth the added effort of dealing with a more difficult tax scheme. The choice would be made by the executor managing the estate, based upon all the characteristics of the particular arrangement. Granted that such an elective treatment would be of advantage to some estates, it does not appear that it is necessary to introduce a generally applicable elective alternative method rather than to merely inject liberalizing aspects into the simplified method providing relief to the specific type of situations for which relief is desired. In this manner, Congress would be pinpointing the recipients of its benefits, instead of simply offering a better bargain to all estates, which would force even the relatively small estates to do a certain amount of shopping before knowing just which law to apply.

If an alternative method is introduced into the code for the period within x -months, then I would recommend the post- x -months plan outlined above in preference to the general trust rules. This plan would more nearly fit even the initial probate administration activity than the present trust rules which are not adapted to the problems of the estate.

IV. CONCLUSION

Even if the present estate income tax rules were to be strictly applied, which may not be the case due to their complexity, the tax consequences of normal probate administration functions would seem to take on a distorted significance. It is one thing to say that because of the nature and operation of an estate there should be substantial opportunities for minimization of tax, and another to make those opportunities a weapon which can alter the rights of conflicting interests within the estate. Many illustrations have been given of the coincidence of a favorable income tax allocation potential under the present law and a cause of action on behalf of some specific interest in the estate which will suffer from such an allocation. This may mean that the instances where it will be possible to get everyone together on maximum tax savings arrangements will approach the close family situations where the income tax generally attempts to preclude a free apportionment of the mere tax burden.

The situation should not be viewed as discouraging. Progress

in perfecting a tax structure is the result of a patient altering and realtering of the machinery to perform the particular tasks which are asked of it. Subchapter J of the 1954 Code has brought with it many notable advances in the science of taxing trusts and estates, but, unfortunately, these have been directed more toward trusts than estates.

It does seem that the time is now ripe for designing a specialized set of code provisions tailored to fit the estate's own methods of operation. This is essentially a problem of providing a workable mechanism for handling estate distributions. For the most part, separate entity treatment would appear to be appropriate. This should have a substantial effect in reducing the consequences of timing the probate administration activities to fit into the various income tax returns. Perhaps, there is also justification for treating this entity as a part of the family income unit, where it is in fact a part of such a unit.

Beyond this, if it is felt that in some situations taxing the estate's income to the precise individual beneficiary receiving it is worth the added complexity in probate estate administration and income tax administration, then a specific set of provisions covering those situations should be created for probate estates, and the present trust comparison abandoned. The basis for a set of such provisions has been presented and it is suggested that this scheme would be more suited to estate operation than the existing provisions.

It is hoped that whatever revised statutory treatment evolves, the federal income taxation of estates will result in the least possible interference with a normal probate administration of decedents' estates.